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No. 95-1284

In the

Supreme Court of the United States

OCTOBER TERM, 1995

NORWEST CORPORATION AND AFFILIATED COMPANIES,
PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

PETITION FOR A WRIT OF CERTIORARI

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66 pp

QUESTIONS PRESENTED

1. Whether the Eighth Circuit erred when it held, in conflict with decisions of the Court of Claims, that a taxpayer was not entitled to foreign tax credits under Internal Revenue Code § 901 with respect to Brazilian income tax paid on interest received from Brazilian borrowers to the extent that Brazil used part of those taxes to provide the borrowers with a "pecuniary benefit."

2. Whether the Eighth Circuit erred when it held, contrary to Internal Revenue Code § 901 and Temp. Treas. Reg. § 4.901-2(f), that a taxpayer was not entitled to foreign tax credits with respect to Brazilian income tax paid on interest received from Brazilian borrowers to the extent that Brazil used part of those taxes to provide a "pecuniary benefit" to third parties who had not engaged in any transaction with the taxpayer.

RULE 29.6 STATEMENT AND PARTIES TO THE PROCEEDING

Petitioner Norwest Corporation has no parent company. The affiliates (other than wholly owned affiliates) of Norwest Corporation are as follows:

Norwest Bank Billings, N.A.

Norwest Bank LaCrosse, N.A.

Norwest Bank Wisconsin Eau Claire, N.A.

Norwest Bank Kalispell, N.A.

Norwest Bank Delta, N.A.

Norwest Bank Fort Collins, N.A.

Norwest Bank Colorado, N.A. (Formerly Norwest Bank Denver, N.A.)

Commonwealth Leasing Corporation

Crestone Capital Management, Inc.

UMCNor, Inc.

The parties to the proceeding appear in the caption.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

RULE 29.6 STATEMENT AND PARTIES TO THE PROCEEDING ii

TABLE OF AUTHORITIES iv

OPINIONS BELOW 1

JURISDICTION 2

STATUTORY PROVISIONS INVOLVED 2

STATEMENT 2

1. Norwest's Loans to Brazilian Borrowers 3
2. Brazil's Taxation of Interest Remitted Abroad and its Pecuniary Benefit Program . . . 4
3. The Tax Court's Ruling 6
4. The Court of Appeals' Decision 7

REASONS FOR GRANTING THE PETITION 9

I. THE EIGHTH CIRCUIT'S DECISION CONFLICTS WITH THE COURT OF CLAIMS' RULINGS IN THE *MEXICAN RAILROAD* CASES 10

II. THE EIGHTH CIRCUIT ERRED IN HOLDING THAT NORWEST'S FOREIGN TAX CREDIT WAS PROPERLY REDUCED BY THE AMOUNT OF THE PECUNIARY BENEFIT PAID TO BRAZILIAN BORROWERS THOUGH NORWEST RECEIVED NO ECONOMIC BENEFIT FROM THAT SUBSIDY . . . 13

A. The Policy And History of Section 901 Show That Subsidies Do Not Reduce Foreign Tax Credits Unless They Result In An Economic Benefit To The U.S. Taxpayer 14

B. Treasury Regulation § 4.901-2(f)(3) Provides That Subsidies Have No Effect Upon Foreign Tax Credits Unless They Result In An Economic Benefit To The U.S. Taxpayer 18

III. THE EIGHTH CIRCUIT ERRED IN HOLDING THAT NORWEST'S FOREIGN TAX CREDIT WAS PROPERLY REDUCED BY THE AMOUNT OF THE PECUNIARY BENEFIT IN THE CASE OF REPASS LOANS 20

CONCLUSION 22

TABLE OF AUTHORITIES

Cases: *Page*

Albright v. *United States*, 173 F.2d 339 (8th Cir. 1949) 17

Bowen v. *Georgetown Univ. Hosp.*, 488 U.S. 204 (1988) 18

Brunswick Corp. v. *Commissioner*, 100 T.C. 6 (1993) 16

Chicago, B. & Q. R.R. v. *United States*, 455 F.2d 993 (Ct. Cl. 1972), rev'd on other grounds, 412 U.S. 401 (1973) 10, 11, 12

Commissioner v. *Callahan Realty Corp.*, 143 F.2d 214 (2d Cir. 1994) 16

Continental Illinois Corp. v. *Commissioner*, 998 F.2d 513 (7th Cir. 1993), cert. denied, 114 S. Ct. 685 (1994) 2, 5, 9, 12, 22

Continental Illinois Corp. v. *Commissioner*, T.C. Memo. 1988-318 (1988), aff'd in relevant part, 998 F.2d 513 (7th Cir. 1993) 6

Hanover Bank v. *Commissioner*, 369 U.S. 672 (1962) 17

Harco Holdings Inc. v. *United States*, 977 F.2d 1027 (7th Cir. 1992) 17

TABLE OF AUTHORITIES—Continued

Page

Hillsboro National Bank v. *Commissioner*, 460 U.S. 370 (1983) 13

Jewett v. *Commissioner*, 455 U.S. 305 (1982) 17

Mars, Inc. v. *Commissioner*, 88 T.C. 428 (1987) . . . 16

Missouri-Illinois R.R. v. *United States*, 381 F.2d 1001 (Ct. Cl. 1967) 11

Missouri Pacific R.R. v. *United States*, 497 F.2d 1386 (1974) 12

Nissho Iwai American Corp. v. *Commissioner*, 89 T.C. 765 (1987) 6, 12

Petroleum Corp. v. *United States*, 939 F.2d 1165 (5th Cir. 1991) 16

Rowan Cos. v. *United States*, 452 U.S. 247 (1981) . . 17

Transco Exploration Co. v. *Commissioner*, 949 F.2d 837 (5th Cir. 1992) 17

United States v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989) 14

TABLE OF AUTHORITIES—Continued

Page

Statutes and Regulations:

Internal Revenue Code:
§ 901 . . . . . *passim*
§ 901(b)(1) 10
§ 901(i) 20, 21
§ 6213(a) 6
§ 7482 7

Proposed Treasury Regulations (1988):
§ 1.901-2(e)(3)(i)(A) 20
§ 1.901-2(e)(3)(ii) 20

Temporary Treasury Regulations (1980):
§ 4.901-(2)(f) 7, 9, 12
§ 4.901-2(f)(3) 8, 18, 22
§ 4.901-2(f)(3)(i) 19
§ 4.901-2(f)(3)(i)(A) 18
§ 4.901-2(f)(3)(ii)(A) 8
§ 4.901-2(f)(3)(ii)(B) 7, 8, 9, 19, 21

Miscellaneous:

H.R. Rep. No. 426, 99th Cong., 1st Sess. (1985) . . . 16

Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 Tax L. Rev. 227 (1984) 15

1 J. Isenbergh, *International Taxation* (1990):
¶ 18.10.1 15
¶ 18.10.2 15

TABLE OF AUTHORITIES—Continued

Page

2 J. Isenbergh, *International Taxation* ¶ 29.12.2 (2d ed. 1996) 17

PLR 7747049 16

PLR 8603008 21

Rev. Rul. 57-106, 1957-1 C.B. 242 . . . . . 15, 18

Rev. Rul. 69-433, 1969-2 C.B. 153 . . . . . 15, 18

Rev. Rul. 78-258, 1978-1 C.B. 239 16

S. Rep. No. 313, 99th Cong., 2d Sess. (1986) 16

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PETITION FOR A WRIT OF CERTIORARI

Norwest Corporation and Affiliated Companies respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-11a) is reported at 69 F.3d 1404. The opinion of the Tax Court (App., *infra*, 12a-25a) is unofficially reported at 63 T.C.M. (CCH) 3023.

JURISDICTION

The judgment of the court of appeals was entered on November 14, 1995, and this petition is filed within 90 days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 901 of the Internal Revenue Code of 1954, 26 U.S.C. § 901, Section 901(i) of the Internal Revenue Code of 1986, 26 U.S.C. § 901(i), and Temporary Treasury Regulation § 4.901-2(f) (1980), are set forth at App., *infra*, 31a-34a.

STATEMENT

At stake in this case is the important question whether United States banks and other lenders that had billions of dollars in loans outstanding to Brazilian borrowers during the late 1970s and early 1980s are entitled to foreign tax credits for Brazilian income tax paid by lenders on interest on those loans, to the extent that Brazil paid a "pecuniary benefit" to borrowers; that is, a rebate of part of the income tax. The Eighth Circuit in this case and the Seventh Circuit in *Continental Illinois Corp.* v. *Commissioner*, 998 F.2d 513 (1993), held that lenders are not entitled to a foreign tax credit to the extent of the pecuniary benefit refunded to borrowers, although the lender received no economic benefit at all from that rebate. In contrast, the Court of Claims has held, in a series of decisions known as the *Mexican Railroad Cases*, that United States lessors are entitled to a credit for Mexican income taxes imposed on rental income, even though the Mexican government paid subsidies to the Mexican lessees in the full amount of the withheld tax.

This case thus presents a square conflict on a critically important issue—an issue upon which turns some $300 million in foreign tax credits. Moreover, a careful review of

the goals of Internal Revenue Code ("IRC") § 901 and of the varying and conflicting positions taken by the Commissioner over the years demonstrates beyond any doubt that the principle embraced in the *Mexican Railroad Cases* is the correct one and that the much narrower entitlement to credits imposed by the Seventh and Eighth Circuits is unwarranted. This Court should grant certiorari to settle the substantial confusion over the rules governing the availability of foreign tax credits that has arisen as a result of these conflicting judicial decisions, and to correct the Seventh and Eighth Circuits' seriously erroneous interpretation of Section 901.

1. Norwest's Loans to Brazilian Borrowers

Norwest Corporation and affiliated companies ("Norwest") made loans to borrowers in Brazil and paid income tax to the Brazilian government on interest earned on those loans. At issue is whether Norwest may claim a foreign tax credit for the full amount of the income tax withheld by the Brazilian government in the tax years 1980 and 1982, as petitioners maintain, or whether, as the Eighth Circuit held, Norwest has no right to a credit to the extent that Brazil gave borrowers a "pecuniary benefit" calculated as a portion of the tax withheld. App., *infra*, 2a.

Norwest made some loans directly to Brazilian borrowers and others to Brazilian banks ("borrowing banks") that in turn would relend or "repass" the funds to Brazilian borrowers ("repass borrowers"). Repass loans (also known as Resolution 63 loans after the government initiative authorizing them) permitted smaller Brazilian companies that otherwise would not have been eligible for foreign loans because of lack of adequate guarantees to obtain such funds. Repass loans were approved on the basis of the borrowing bank's creditworthiness; Norwest had no legal relationship with the repass borrower, and in general did not know the repass borrower's identity. App., *infra*, 17a.

2. Brazil's Taxation of Interest Remitted Abroad and its Pecuniary Benefit Program

During the relevant time period, the Brazilian government exerted tight control over foreign lending into Brazil and over the supply of foreign currency. By law, the Banco Central do Brasil ("Central Bank") registered and approved all loans from foreign lenders to Brazilian borrowers. Through the loan registration process, it also established maximum allowable interest rates and minimum repayment terms. Once the Central Bank approved a foreign loan, the lender remitted the funds in foreign currency to the borrower via a commercial bank in Brazil. The borrower was required to sell the foreign currency to the Brazilian commercial bank and to receive the loan funds converted into Brazilian currency at the official rate of exchange. App., *infra*, 14a.

Brazil imposes on foreign lenders a withholding tax on interest paid to them by Brazilian borrowers. Except for a ten-month period in 1974 and 1975, the withholding tax has been 25% since 1959. App., *infra*, 20a. Brazil developed an air-tight system to ensure that this withholding tax would be paid. In order to make an interest payment, the borrower had to purchase foreign currency from a Brazilian bank at the official exchange rate. The bank then tendered the foreign currency to the borrower. But to initiate this transaction, the borrower had to submit the withholding tax due on the interest payment to the commercial bank. Upon obtaining approval from the Central Bank, the commercial bank paid the tax simultaneously with making the interest payment. This system ensured that no interest payment could be made without payment of the withholding tax due. *Id.* at 14a-15a & n.2.

In 1974, the level of Brazil's foreign currency reserves dropped sharply as a result of higher prices paid for oil due to the OPEC oil embargo. Because Brazilian currency is not convertible into foreign currency on international markets, Brazil must maintain a large supply of foreign currency in

order to engage in international trade and finance its trade deficit. To obtain foreign currency, the Brazilian government had traditionally provided incentives to Brazilian companies to encourage them to borrow from foreign countries. C.A. App. No. 1, ¶¶ 17-20, 25. These incentives were not sufficient, however, to solve the reserve crisis caused by the 1974 oil embargo. *Id.* at ¶¶ 57-59.

In August 1975, the Central Bank instituted a system whereby a Brazilian borrower received a "pecuniary benefit" equivalent to a percentage of the withholding tax paid on interest payments made to the foreign lender, which effectively reduced the cost of the loan to the borrower. Upon payment of the 25% withholding tax to a Brazilian commercial bank, the bank credited the account of the borrower with the pecuniary benefit. The transfer of the collected taxes to the Brazilian authorities by the commercial bank and the bank's reimbursement of the borrower for the pecuniary benefit were separate and distinct financial transactions. In the case of a Resolution 63 loan, the borrowing bank was required by law to pass the pecuniary benefit on to the repass borrower. App., *infra*, 16a-18a.

Brazil's pecuniary benefit system was not driven by any concern with the application of United States foreign tax credit rules, nor otherwise designed to benefit foreign lenders. The pecuniary benefit system resulted in an economic benefit to borrowers, but never in an economic benefit to foreign lenders. In a contemporaneous newspaper article, Brazil's Finance Minister explained that the purpose of the pecuniary benefit system was to provide an incentive for foreign borrowing. C.A. App. No. 32. Discussing Brazil's implementation of the pecuniary benefit incentive, the Seventh Circuit noted that Brazil "want[ed] to preserve its stimulus for foreign investment yet stem a foreign-currency hemorrhage, and it chose a method of doing so *that it might have chosen were there no U.S. foreign tax credit.*" *Conti-*

nental Illinois Corp., 998 F.2d at 519 (Posner, J.) (emphasis added).

3. The Tax Court's Ruling

Internal Revenue Code Section 901 allows a corporation to claim as a credit against its Federal income tax "the amount of any income * * * taxes paid or accrued during the taxable year to any foreign country."[1] Norwest filed a petition in the tax court, which had jurisdiction pursuant to IRC § 6213(a), claiming it had overpaid its taxes for the years 1980 and 1982. Specifically, Norwest claimed that Section 901 entitled it to credits for the full amount of withholding taxes paid on interest on loans to Brazilian borrowers, including the amount of pecuniary benefit paid to borrowers. The case was submitted to the tax court on stipulated facts. App., *infra*, 12a-13a.

The tax court held that the pecuniary benefits to borrowers reduced Norwest's payment of tax and hence its foreign tax credit. The court based its decision on the theory of "substance over form." Relying on *Nissho Iwai American Corp.* v. *Commissioner*, 89 T.C. 765 (1987), and *Continental Illinois Corp.* v. *Commissioner*, T.C. Memo. 1988-318 (1988), aff'd in relevant part & rev'd in part on other grounds, 998 F.2d 513 (7th Cir. 1993), the court reasoned that payment of the tax and receipt of the subsidy should "be viewed together in determining the amount of foreign taxes creditable." To see the payment of the tax and the receipt of the pecuniary benefit as two transactions, the court held, "would ignore the true unity of the transaction and elevate form over substance." Norwest was not subject to double taxation by the disallowance of a credit for the pecuniary benefits "because the pecuniary benefit portion was not paid

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[1] Except as otherwise noted, all references to the Code and regulations are to provisions in force during the period at issue, 1980 and 1982.

to the Brazilian Treasury. Following the enactment of the 1975 pecuniary benefit legislation, the Brazilian tax rate was in reality 5 percent, not 25 percent." App., *infra*, 22a-23a.

The tax court also rejected Norwest's alternative contention that even if it was not entitled to credit for the full amount of withholding tax paid on interest on loans to direct Brazilian borrowers, the IRS's own regulations provided that pecuniary benefits to repass borrowers should not reduce Norwest's credit for taxes paid on Resolution 63 loans. Temp. Treas. Reg. § 4.901-2(f)(3)(ii)(B) provided that the amount of indirect subsidies—those subsidies provided by a foreign country to a person who "[e]ngages in a business transaction" with the taxpayer—is not income tax paid to a foreign country. Norwest engaged in no business transaction with the repass borrower, Norwest argued, and so Temp. Treas. Reg. § 4.901-2(f) did not apply. While acknowledging that two distinct transactions were involved in repass loans—one between the lender and the borrowing bank and one between the borrowing bank and the repass borrower—the tax court rejected Norwest's argument on the ground that payment of the tax and the repass borrower's receipt of the pecuniary benefit were "inextricably linked to the transaction between the foreign lender and the Brazilian bank." App., *infra*, 25a.

4. The Court of Appeals' Decision

Norwest, supported by two *amicus* briefs filed by members of a concerned banking community, appealed to the Eighth Circuit, which had jurisdiction pursuant to IRC § 7482. The court of appeals declined to rely on the "form-over-substance" theory upon which the tax court had adjudicated the case. App., *infra*, 11a n.6. Instead, the court deferred to the Commissioner's interpretation of Temp. Treas. Reg. § 4.901-2(f) to bar Norwest's claim to credits. *Id.* at 7a-11a.

The court of appeals held that the Commissioner had reasonably determined that pecuniary benefits were "used directly or indirectly by [Brazil] to provide a subsidy * * * to the taxpayer," and foreign tax credits in the amount of the pecuniary benefits were thus disallowed by Temp. Treas. Reg. § 4.901-2(f)(3)(ii)(A). The Commissioner had justifiably relied on Temp. Treas. Reg. § 4.901-2(f)(3)(ii)(B), which defines a subsidy to the taxpayer to include payment of a subsidy to a person with whom the taxpayer "[e]ngages in a business transaction," where that subsidy is determined "by reference to the amount of income tax, or the base used to compute the income tax" imposed on the taxpayer. App., *infra*, 5a-8a.

With little discussion or analysis, the court of appeals rejected Norwest's argument that Temp. Treas. Reg. § 4.-901-2(f)(3)(ii)(B) was inconsistent with the language and purpose of IRC § 901. According to the court of appeals, the regulation "implement[ed] the congressional mandate in [a] reasonable manner" when it construed "the statutory language 'paid or accrued' [to a foreign government] to mean circumstances in which the foreign tax * * * has in substance been paid." App., *infra*, 7a-8a. The regulation also achieved Section 901's purpose of preventing double taxation, the court ruled, because pecuniary benefits could reasonably be treated as not being part of the tax paid to the Brazilian government but as "in effect reducing the tax rate * * * from 25% to 5%." *Id.* at 8a.

The Eighth Circuit also rejected Norwest's contention that in order to be consistent with the policy and history of IRC § 901, as well as with numerous prior judicial and IRS interpretations of that provision, Temp. Treas. Reg. § 4.901-2(f)(3) must be interpreted to reduce foreign tax credits only where the taxpayer received an economic benefit. Without discussion, the court of appeals simply held that the Commissioner "must be given leeway" when deciding whether a subsidy "to a foreign business partner of a U.S. taxpayer

should be deemed a subsidy to the taxpayer, disentitling [it] to a foreign tax credit." App., *infra*, 8a-9a.

With regard to repass loans, the Eighth Circuit acknowledged that the transactions between Norwest and borrowing banks were separate from the transactions between borrowing banks and repass borrowers. Despite Temp. Treas. Reg. § 4.901-2(f)(3)(ii)(B)'s express limitation to circumstances where the parties "engag[e] in a business transaction," the court conclusorily held, relying on *Continental Illinois Corp.*, 998 F.2d 513, that because the borrowing bank passed the pecuniary benefit it received on to repass borrowers, Resolution 63 loans fit "within the letter as well as the spirit of the subsidy regulation." App., *infra*, 11a.

REASONS FOR GRANTING THE PETITION

The Eighth Circuit's decision denied a foreign tax credit to United States lenders for Brazilian income tax withheld on interest received on loans to Brazilian borrowers to the extent that Brazil provided a pecuniary benefit to borrowers in an amount equal to a portion of the tax. In so holding, the court unquestionably imposed double taxation on Norwest and countless other lenders to Brazil. The court of appeals' ruling results in lenders having to pay both Brazilian and United States taxes on interest income on account of a pecuniary benefit to *borrowers* that resulted in no economic benefit of any kind to the *lender*. Internal Revenue Code § 901, as the Court of Claims made clear in the *Mexican Railroad Cases*, was intended to prevent such double taxation. The Commissioner's interpretation of Temp. Treas. Reg. § 4.901-2(f) to justify double taxation in this case—an interpretation to which the Eighth Circuit deferred—is inconsistent with the Court of Claims' construction of Section 901 and with the Commissioner's own prior view of the statutory mandate. This Court's review is warranted to settle the square conflict between the decision below and the *Mexican Railroad Cases* and to restore Section 901, as it applies to the years at issue, to its intended purpose of preventing double taxation.

I. THE EIGHTH CIRCUIT'S DECISION CONFLICTS WITH THE COURT OF CLAIMS' RULINGS IN THE *MEXICAN RAILROAD CASES*

In the relevant tax years, the Internal Revenue Code was silent as to the effect on the availability of a foreign tax credit of a foreign country's provision of pecuniary benefits or subsidies. IRC Section 901 simply provided that a taxpayer was allowed a credit against United States federal income tax in "the amount of any taxes * * * *paid or accrued* during the taxable year to any foreign country." 26 U.S.C. § 901(b)(1) (emphasis added). Interpreting Section 901 in the series of *Mexican Railroad Cases* decided between 1967 and 1974, the Court of Claims rejected the Commissioner's contention that a taxpayer was not entitled to a credit for foreign income taxes pursuant to Section 901 insofar as the foreign government provided a subsidy in an amount based upon the tax. The *Mexican Railroad Cases* are in direct conflict with the Eighth Circuit's decision in this case, for Section 901 did not change between 1967 and 1982; exactly the same statute was at issue below and in the Court of Claims' earlier decisions.

The facts underlying the *Mexican Railroad Cases* are essentially the same. In each case, a United States railroad sought a foreign tax credit under Section 901 for taxes paid to the Mexican government on income received from Mexican railroads for the rental of rolling stock. Although the Mexican income tax statute provided for the withholding of 10 percent of rental payments as income tax and obligated the Mexican lessee to pay the withheld tax directly to the Mexican treasury, the railroads and the Mexican government foresaw difficulties in administering this tax. In consequence, they entered into an agreement to govern the calculation and payment of the tax. See *Chicago, B. & Q. R.R.* v. *United States*, 455 F.2d 993, 1021-1022 (Ct. Cl. 1972) (setting out the agreement), rev'd on other grounds, 412 U.S. 401 (1973). By the terms of this agreement, Mexican lessee

railroads withheld as tax the difference between a defined "Mexican per diem rental rate" and "American per diem rental rate" and remitted this tax to the Mexican government "as the total obligations of the American * * * Railroads, in accordance with the Income Tax Law of Mexico regarding the rental of rolling stock." *Id.* at 1021. Paragraph 7 of the agreement guaranteed a subsidy to the lessees based on the amount of tax withheld, stipulating that

> [t]he Ministry of Finance and Public [C]redit will grant the National Railways of Mexico and the Mexican Railway for as long as this obligation of payment of tax on rental of rolling stock exists, *a subsidy equal to the amount of taxes withheld.*

Id. at 1022 (emphasis added).

In *Missouri-Illinois R.R.* v. *United States*, 381 F.2d 1001 (Ct. Cl. 1967), the seven-judge Court of Claims considered whether Missouri-Illinois was entitled to a foreign tax credit for 1957 for tax withheld according to the terms of this agreement. The court rejected the Commissioner's argument that the subsidy paid by the Mexican government to the Mexican railroads barred Missouri-Illinois' claim to a foreign tax credit. It held that the Commissioner's focus on "the disposition by the Mexican Government of the proceeds of the tax which [Missouri-Illinois] paid" was "not * * * helpful to a determination of the real question" whether the tax was an income tax. *Id.* at 1003-1004. Focusing on the latter question, the court held that the tax paid under the agreement was an income tax or tax paid in lieu of an income tax and that Missouri-Illinois was "entitled to deduct the full amount of [the] tax paid * * * as a credit against United States income tax." *Id.* at 1004.

In *Chicago, B. & Q. R.R.*, the Court of Claims considered a virtually identical claim for a refund. A six-member majority of the court once again rejected the Commissioner's proffered reading of Section 901 and allowed the credit for

Mexican taxes even though Mexican authorities paid a subsidy to the Mexican railroads in the amount of the tax. The Court explained:

> The fact that the Mexican Government later granted subsidies to the Mexican railroads equal to the plaintiff's tax payments does not change the fact that the plaintiff made the payments. This is wholly an internal Mexican affair that is of no concern to us.

455 F.2d at 1023. Relying on the decisions in *Missouri-Illinois* and *Chicago, B. & Q.*, a unanimous three-judge panel of the Court of Claims reached the same result—over the same objection from the Commissioner—in *Missouri Pacific R.R.* v. *United States*, 497 F.2d 1386, 1394-1395 (1974).

These decisions, from which the Court of Claims has never retreated, are wholly inconsistent with the ruling of the Eighth Circuit in this case that Temp. Treas. Reg. § 4.901-2-(f) was a permissible interpretation of IRC Section 901. The Temporary Treasury Regulation, the Eighth Circuit held, reasonably interpreted Section 901 to disallow a credit to the extent the foreign taxing authority provided a subsidy to the foreign party to a transaction; the *Mexican Railroad Cases*, in contrast, interpreted Section 901 to allow a credit in those circumstances. The conflict could not be clearer.

This conflict is exacerbated by the decisions of other courts. The Seventh Circuit in *Continental Illinois Corp.*, 998 F.2d at 519-520, adopted the same position as the Eighth Circuit in this case, without discussing the Court of Claims' earlier and inconsistent rulings. And the Tax Court in *Nissho Iwai American Corp.*, 89 T.C. at 777, in similarly holding the credit unavailable to the extent of the Brazilian pecuniary benefit, frankly acknowledged that its ruling conflicted with the *Mexican Railroad Cases* but "decline[d] to follow the holdings of those cases." The stark conflict between the Court of Claims on the one hand and the Tax Court, Seventh

Circuit, and Eighth Circuit on the other, concerning an important tax question upon which hundreds of millions of dollars in tax credits turns, warrants this Court's review.

This Court's intervention is all the more important because the Eighth Circuit's decision is also at odds with principles enunciated in *Hillsboro National Bank* v. *Commissioner*, 460 U.S. 370 (1983). In *Hillsboro*, the taxpayer bank had paid state taxes imposed on its shareholders, and had properly deducted the payments pursuant to IRC Section 164(e), which addressed precisely that situation. When the state tax in question was later repealed, the taxes were refunded not to the bank but directly to the bank's shareholders on whose behalf the taxes had been paid. This Court rejected the Commissioner's contention that the refund to shareholders offset the bank's Section 164(e) deduction, so that the refund should be included in the bank's income under the tax benefit rule. The critical factor in this Court's analysis was that the bank and its shareholders were "independent of one another." *Id.* at 394. Thus, the bank's tax payment was "not negated by a refund" to the shareholders, as it would have been by a refund to the corporation. *Ibid.* The decision in *Hillsboro* supports petitioners' view that a subsidy does not negate a tax paid unless the economic benefit of the subsidy is returned to the taxpayer, and casts considerable doubt on the court of appeals' ruling below.

II. THE EIGHTH CIRCUIT ERRED IN HOLDING THAT NORWEST'S FOREIGN TAX CREDIT WAS PROPERLY REDUCED BY THE AMOUNT OF THE PECUNIARY BENEFIT PAID TO BRAZILIAN BORROWERS THOUGH NORWEST RECEIVED NO ECONOMIC BENEFIT FROM THAT SUBSIDY

Norwest did not share in the subsidies paid to its Brazilian borrowers. The borrowers did not transfer any part of the subsidy to Norwest. Nor did Norwest "capture" the economic benefit of the subsidy by raising interest rates. To the contrary, the Commissioner and her witnesses agreed that

as a result of Brazil's rigid controls on interest rates, "[i]nterest on foreign loans did not increase as a result of" the subsidy legislation. C.A. App. No. 34, at 180. Reinstatement of the 25% withholding tax rate and enactment of the subsidy system simply restored U.S. lenders to "exactly the same" position they had always had under Brazil's traditional 25% withholding rate. *Id.*, No. 72, at 1304.

The court of appeals held that this total lack of economic benefit to Norwest "is not relevant" to the question whether Norwest could take a foreign tax credit for the amount of the pecuniary benefit. App., *infra*, 8a-9a. That ruling is in error. It is inconsistent with IRC § 901, as reflected in the prior consistent position of the Commissioner, and even with the Treasury regulation in issue. And if left uncorrected, it would result in enormous, unanticipated, and unjustified liabilities for U.S. lenders.

A. The Policy And History of Section 901 Show That Subsidies Do Not Reduce Foreign Tax Credits Unless They Result In An Economic Benefit To The U.S. Taxpayer

Internal Revenue Code § 901 provides a tax credit for foreign taxes "paid or accrued." During the years in question, the Code was silent about whether a foreign country's provision of a subsidy tied to the amount of local tax paid by a U.S. entity reduced the amount of tax paid or accrued by that entity. In such circumstances, this Court has made clear, a Code provision is to be interpreted in light of its history, purpose, and operation. See *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132, 139 (1989). The history, purpose, and operation of the foreign tax credit demonstrate that a subsidy that provides no economic benefit to the U.S. taxpayer does not reduce the amount of foreign taxes paid or accrued and so does not reduce the credit.

The purpose of the foreign tax credit is to protect against double taxation of foreign income. *Goodyear*, 493 U.S. at

139. When a foreign tax is refunded *to the taxpayer*, obviously no tax has been "paid" and the disallowance of foreign tax credit does not result in double taxation. See 1 J. Isenbergh, *International Taxation* ¶ 18.10.1 (1990) ("*Isenbergh Treatise*"). But, given the purpose of Section 901 to avoid double taxation, a subsidy paid *to a third party* such as a foreign borrower should not reduce the taxes "paid" by the U.S. lender (or correspondingly reduce the lender's foreign tax credits) where the lender receives no economic benefit from the subsidy.

As a leading commentator has explained, if the lender does not receive an economic benefit from the subsidy, then the lender is still out-of-pocket for the entire amount of the foreign tax and will be subject to double taxation if it does not receive a credit for the full amount of the tax. Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 Tax. L. Rev. 227, 247 (1984) ("*Isenbergh Article*"). The purpose of the statute requires a reduction in a U.S. taxpayer's foreign tax credit only if the U.S. taxpayer shares in the subsidy. *Isenbergh Treatise* ¶ 18.10.2.

Unsurprisingly, this is exactly the manner in which the Commissioner initially interpreted Section 901, prior to the events involved in this case. In a 1957 Revenue Ruling, the Commissioner ruled that a subsidy paid to a foreign corporation equal to the taxes imposed on two U.S. corporations when they sold their assets to the foreign corporation did not reduce the foreign tax credit claimed by the U.S. corporations because the taxpayers did not benefit from the subsidy. Rev. Rul. 57-106, 1957-1 C.B. 242. In contrast, the Commissioner's next ruling on subsidies concerned a situation in which a subsidy was paid to the taxpayer's subsidiary, thereby reducing the tax paid and, accordingly, the foreign tax credit. Rev. Rul. 69-433, 1969-2 C.B. 153.

Subsequently, the Commissioner directly addressed the issue here—the U.S. tax consequences of Brazil's pecuniary benefit system. In twenty-two separate private letter rulings

issued between 1976 and 1978, the Commissioner indicated that the subsidy paid to Brazilian borrowers *did not* reduce the foreign tax credit of U.S. lenders. The express rationale of these rulings was that the Brazilian subsidy was paid "to a party other than the party liable for the tax"—just as in Norwest's case. PLR 7747049, C.A. App. No. 88.

Not until 1978—after 21 years during which it took precisely the opposite view of exactly the same statutory language—did the Service reverse its prior position to hold that whether a subsidy provided economic benefit to the taxpayer was no longer the touchstone of the foreign tax credit's availability. Rev. Rul. 78-258, 1978-1 C.B. 239. The Commissioner subsequently embodied its new position in Temp. Treas. Reg. § 4.901-2(f) (1980). In the absence of any intervening amendment to the statute, the change of position in that regulation is inexplicable.[2] The Commissioner's new "position misconceives * * * who derives the

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[2] Congress amended IRC § 901 in 1986 to codify the Commissioner's position on the subsidy issue set forth in Rev. Rul. 78-258. This amendment confirms that the Commissioner's current position regarding subsidies had no basis in the statute during the years in question. The House Bill originally provided that the 1986 amendment would apply to tax years after 1985. H.R. Rep. No. 426, 99th Cong., 1st Sess. 352 (1985). A provision in the final bill, however, delayed the effective date one more year. See S. Rep. No. 313, 99th Cong., 2d Sess. 325 (1986). Although Congress stated that no inference should be drawn from its action about the validity of the temporary regulation, in similar circumstances courts have held that the adoption of an amendment to a statute with a prospective effective date is an indication that the amendment is a change in existing law, even if the amendment is phrased as a "clarification." *Commissioner* v. *Callahan Realty Corp.*, 143 F.2d 214, 216 (2d Cir. 1944); *Mars, Inc.* v. *Commissioner*, 88 T.C. 428, 434-435 n.11 (1987); see also *Petroleum Corp.* v. *United States*, 939 F.2d 1165, 1169 (5th Cir. 1991); *Brunswick Corp.* v. *Commissioner*, 100 T.C. 6 (1993).

economic benefit of the subsidy, and therefore ultimately who bears the burden of the foreign tax," Professor Isenbergh has explained, and is "wholly oblivious of economic reality." 2 J. Isenbergh, *International Taxation* ¶ 29.12.2, at 29:14 (2d ed. 1996). The case law is clear that the Commissioner's new position is not entitled to the deference accorded to it by the Eighth Circuit.

The Service's rulings between 1957 and 1978 are "significant since they disclos[e] the interpretation of the statute by the agency charged with administering the revenue laws." *Transco Exploration Co.* v. *Commissioner*, 949 F.2d 837, 840 (5th Cir. 1992); see also *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 686-688 (1962). As the Commissioner's initial, contemporary, and long-held views, they are a particularly reliable guide to the statute's meaning. See *Harco Holdings Inc.* v. *United States*, 977 F.2d 1027, 1035 (7th Cir. 1992) (where Commissioner suddenly took new position as to statute's meaning, Commissioner's prior position held to constitute more reliable guide to interpretation).

Because it is diametrically opposed to the Commissioner's prior (and accurate) determination that the purpose of IRC § 901 required that the foreign tax credit not be reduced by a subsidy that provided no economic benefit to the taxpayer, the Commissioner's new position carries little weight. See *Jewett* v. *Commissioner*, 455 U.S. 305, 318 (1982) (Commissioner's interpretation is entitled to respect when it "has been *consistent over the years*") (emphasis added); *Albright* v. *United States*, 173 F.2d 339, 344-345 (8th Cir. 1949) (no deference accorded to Commissioner's inconsistent and ambiguous interpretations of statute); see also *Rowan Cos.* v. *United States*, 452 U.S. 247, 253 (1981) (manner in which regulation that is not a contemporaneous construction of statute evolves merits inquiry). Indeed, when an agency takes a new "litigating position" that is inconsistent with prior "administrative practice," as occurred here,

this Court has held that its new position is entitled to *no* deference. *Bowen* v. *Georgetown Univ. Hosp.*, 488 U.S. 204, 212 (1988).

In Rev. Rul. 57-106, Rev. Rul. 69-433, and the twenty-two private letter rulings, the Commissioner carefully interpreted Section 901 to carry out the purpose of the statute by holding that subsidies do not reduce the tax "paid" unless the economic benefit of the subsidy reaches the taxpayer. This interpretation of the statute, consistently followed over a 21-year period, was certainly correct; and it is the interpretation of Section 901 consistently upheld by the Court of Claims in the *Mexican Railroad Cases*, as discussed in Section I, *supra*. The court of appeals erred in rejecting this interpretation of Section 901 in favor of deference to the Commissioner's belated, unjustified, and completely inconsistent change of position. This Court should grant certiorari to correct this error as to an important tax question that affects many U.S. lenders, and also to provide guidance to the lower courts about the weight to be attached to IRS and other agency interpretative regulations in similar circumstances.

B. Treasury Regulation § 4.901-2(f)(3) Provides That Subsidies Have No Effect Upon Foreign Tax Credits Unless They Result In An Economic Benefit To The U.S. Taxpayer

The Commissioner's belated reinterpretation of IRC § 901 is insupportable as a matter of statutory construction. In any event, the regulation that the Commissioner claims (and the Eighth Circuit agreed) sets out that new interpretation is, at a minimum, highly ambiguous and misleading to U.S. lenders. The plain language of Temp. Treas. Reg. § 4.901-2(f)(3) indicates that only a subsidy that provides an economic benefit to the taxpayer reduces foreign tax credits.

By its terms, the regulation (set out in full at App., *infra*, 32a-34a) applies only if a subsidy is provided "directly or indirectly * * * to the taxpayer." Temp. Treas. Reg. § 4.901-2(f)(3)(i)(A). An indirect subsidy is defined so that

"[a] foreign country is considered to provide a subsidy to a person if the country provides a subsidy to another person that * * * [e]ngages in a business transaction with the first person." *Id.* § 4.901-2(f)(3)(ii)(B). But there is nothing in this indirect subsidy definition to indicate that it is not subject to the "general rule" in Section 4.901-2(f)(3)(i) that disallowed subsidies be provided "to the taxpayer." And the use of the term "is considered" in the indirect subsidy provision (rather than the simple command that a foreign country "provides" a subsidy in the situation described) suggests that exceptions to accommodate the general economic benefit rule were contemplated.

This interpretation of the regulation, moreover, makes perfect sense. The indirect subsidy rule is apparently directed at situations in which a U.S. taxpayer may be able to "capture" the economic benefit of a subsidy. For example, if a U.S. taxpayer "engages in a business transaction" with a person receiving a subsidy, the U.S. taxpayer may attempt to charge a higher price or interest rate in order to capture the economic benefit of the subsidy. The use of the word "considered" and the explicit limitation of the regulations to specific third-party recipients indicates that the drafters of the regulations presumed that those third parties would likely pass the subsidy, or the economic benefit of the subsidy, back "to the taxpayer." Such a presumption, however, must be rebuttable because there is no basis, in the statute or otherwise, for reducing the tax paid by a taxpayer for an amount received by another party unless the taxpayer derived some economic benefit therefrom.

Indeed, that is exactly the interpretation one of the Commissioner's key advisers placed on the regulation. D. Kevin Dolan, the Commissioner's Associate Chief Counsel (International), stated that the regulations were not concerned with whether "the withholding agent/payor is subsidized," but only with whether "the taxpayer indirectly receives a subsidy." C.A. App. No. 91. Because it is undisputed that

the Brazilian pecuniary benefit system did not result in an actual benefit to U.S. lenders (see pages 13-14, *supra*), the concern expressed in the regulation is not present in this case. By its terms, the regulation does not apply to the subsidies paid to the Brazilian borrowers because Norwest (like other U.S. lenders) did not share in those subsidies.[3]

III. THE EIGHTH CIRCUIT ERRED IN HOLDING THAT NORWEST'S FOREIGN TAX CREDIT WAS PROPERLY REDUCED BY THE AMOUNT OF THE PECUNIARY BENEFIT IN THE CASE OF REPASS LOANS

For the reasons set out above, neither IRC § 901 nor the 1980 Temporary Treasury Regulations justify denial of the full foreign tax credit in the case of *any* of the loans at issue. It is particularly clear, however, that the court of appeals erred when it held that the credit should be reduced by the amount of the pecuniary benefit Brazil provided to the ultimate "repass" borrower under a Resolution 63 loan.

The court of appeals acknowledged that, in the case of Resolution 63 loans, the transaction between the foreign lender and the borrowing bank was "separate from the transactio[n]" between the borrowing bank and the repass borrower. App., *infra*, 11a. That finding, which was clearly

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[3] The Commissioner later proposed new regulations under amended Section 901(i) (see page 16 n.2, *supra*) which eliminated the "to the taxpayer" requirement. These regulations provided that prohibited subsidies included subsidies "to any party to the transaction, or to any party to a related transaction." Prop. Treas. Reg. § 1.901-2(e)(3)(i)(A) (1988; adopted 1991); C.A. App. No. 77. They stated as well that "[t]he fact that the U.S. taxpayer may derive no benefit from the subsidy is irrelevant in determining whether a subsidy exists." *Id.* § 1.901-2(e)(3)(ii). These changes were effective only after 1986, and thus confirm that prior to that time the regulations did not apply unless the economic benefit of the foreign subsidy was provided "to the taxpayer."

correct given the structure of repass loans (see page 3, *supra*), mandates that the pecuniary benefit to a repass borrower not be treated as an indirect subsidy to the lender, for Temp. Treas. Reg. § 4.901-2(f)(3)(ii)(B) on its face applies only when the person receiving the subsidy "[e]nga-ges in a business transaction *with* the" taxpayer (emphasis added).

The Commissioner's prior administrative practice confirms Norwest's reading of the plain language of the temporary treasury regulation. To begin with, in 1979 the Commissioner rejected proposed regulations that would have precluded a foreign tax credit in the amount of a subsidy whenever the recipient of the subsidy was engaged "directly or indirectly in a business transaction with the taxpayer"—language that would have reached the subsidy provided to a repass borrower. C.A. App. No. 78. The Commissioner instead adopted the more restrictive requirement that the subsidy recipient have engaged "in a business transaction with the" taxpayer. Even more telling, in 1985, three years *after* the last tax year involved in this case, the Commissioner concluded in Private Letter Ruling 8603008 that the subsidy regulations *did not* reduce the amount of foreign tax credit in Resolution 63 loans because repass borrowers did not "engage in business transactions" with the U.S. lender. C.A. App. No. 87.[4]

Neither the Eighth Circuit here nor the Seventh Circuit in *Continental Illinois* explained their conclusions that repass loans fell "within the letter as well as the spirit of the

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[4] Amended IRC § 901(i), applicable to tax years after 1986, disallows foreign tax credits if a subsidy is provided to "any party to the transaction *or to a related transaction*." That a statutory reference to "related transactions" was thought necessary to reach three-party loans further demonstrates that repass loans were not covered by the 1980 temporary regulations at issue here, which omitted this critical language.

subsidy regulation." App., *infra*, 11a; *Continental Illinois Corp.*, 998 F.2d at 520. The plain language of Temp. Treas. Reg. § 4.901-2(f)(3), the Commissioner's prior administrative practice, and subsequent changes to the regulations all make clear that the regulation was not intended to reach repass loans. The tax penalty to U.S. lenders for this error is in, at least, the tens of millions of dollars, and in addressing the more general conflict with the Court of Claims described above this Court should take this opportunity to rectify the Eighth and Seventh Circuit's misconstruction of the indirect subsidy regulation.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

Nos. 93-1274/1741

NORWEST CORPORATION, formerly known as Northwest Bancorporation and Affiliated Companies, and AFFILIATED COMPANIES; NORWEST BANK, FORT DODGE, N.A., formerly First National Bank; NORWEST BANK, MARION, N.A., formerly First National Bank of Marion,

v.

Commissioner of Internal Revenue

On Appeal From the United States District Court For the Eastern District of Missouri

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Submitted: November 8, 1993

Before: McMILLIAN and MAGILL, Circuit Judges, and JACKSON,* District Judge

(Opinion Filed November 14, 1995)

Before: McMILLIAN and MAGILL, Circuit Judges, and JACKSON,* District Judge

McMILLIAN, *Circuit Judge*.

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*The Honorable Carol E. Jackson, United States District Judge for the Eastern District of Missouri, sitting by designation.

Norwest Corporation and Affiliated Companies (Norwest) appeal from a final order entered in the United States Tax Court[1] assessing and ordering Norwest to pay income tax deficiencies for its 1980 and 1982 taxable years. *Norwest Corp. v. Commissioner*, 63 T.C.M. (CCH) 3023 (1992). For reversal, Norwest claims that the tax court improperly held that it was not entitled to foreign tax credits (FTCs) under 26 U.S.C. § 901 for income taxes paid to the Brazilian government pursuant to Brazil's tax on interest income earned by foreign lenders. Norwest claims the Commissioner erroneously determined it was not entitled to FTCs for portions of the tax the Brazilian government returned to borrowers pursuant to its "pecuniary benefit" program. The Commissioner cross-appeals the tax court's rejection of her alternative defense that Norwest deserved no FTCs because Norwest was not legally liable for the tax. For the reasons discussed below, we affirm the decision of the tax court and deny the cross-appeal.

I. Background

Norwest is the parent company of certain corporations that filed consolidated income tax returns for 1980 and 1982. During those years Norwest made loans to Brazilian borrowers, and Brazil imposed a tax on interest earned by foreign lenders of 25% of the lenders' interest income per payment (local tax). The Brazilian government collected this local tax by withholding the full amount of the local tax when borrowers purchased foreign currency to make their interest payments. Withholding was mandatory because Brazilian law required borrowers to obtain their foreign currency from local banks. Brazilian law also granted a "pecuniary benefit," or subsidy, to those borrowing from foreign lenders. When such borrowers would purchase foreign currency for interest payments, the bank handling the transaction would also credit the borrower's account for the pecuniary benefit. The government set the pecuniary benefit as a percentage of the local tax that the borrower was required to set aside through the withholding system.

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[1] The Honorable Julian I. Jacobs, Judge, United States Tax Court.

Brazil allowed its larger banks to borrow money from foreign sources and then re-lend the money to secondary local, or "repass," borrowers. The Brazilian government extended the pecuniary benefit to the repass borrowers during the years at issue by requiring the initial borrowers to allocate the subsidies pro-rata to the repass borrowers.

During the years at issue, Norwest made loans to Brazilian borrowers. Some of these borrowers executed repass loans. Norwest, on its 1980 and 1982 tax returns, desired to claim FTCs under 26 U.S.C. § 901[2] for the amounts withheld for the local tax. Norwest, however, subtracted from this amount the subsidies granted under the pecuniary benefit system, ostensibly to comply with revenue and private letter rulings by the Commissioner. Norwest subsequently filed a petition for redetermination with the tax court in 1986, claiming an overpayment of tax and seeking a refund of these amounts. The Commissioner disallowed this request, and Norwest filed suit in the tax court. The parties submitted the case with all facts fully stipulated. The tax court rejected the Commissioner's argument that Norwest was not legally liable for the local tax, and thus not entitled to a FTC altogether, and concluded that Norwest was entitled to a FTC for part of the local tax. This appeal by Norwest and cross-appeal by the Commissioner followed.

II. Discussion

A. *The Commissioner's Cross-Appeal—Legal Liability for Tax*

Under 26 U.S.C. § 901, a domestic corporation may claim as a credit (subject to limitations inapplicable in the present case) against its federal income tax liability "the amount of any income...taxes paid or accrued during the taxable year to any foreign country." The purpose of the FTC is to reduce international double taxation. *See American Chicle Co. v. United States*, 316 U.S. 450, 451 (1942). A foreign tax is creditable only for the

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[2] Unless otherwise noted, all statutory citations are for the years at issue.

taxpayer that is legally liable for the tax. Temp. Treas. Reg. § 4.901-2(g)(1), 45 Fed. Reg. 75655 (Nov. 17, 1980), 26 C.F.R. § 4.901-2(g)(1) (1981). The liability of the United States taxpayer for the foreign tax is determined in accordance with United States tax principles. *Biddle v. Commissioner*, 302 U.S. 573, 579 (1938).

We address the Commissioner's cross-appeal first because, if successful, this argument renders Norwest's appeal moot. The Commissioner argues that Norwest is not legally liable for the local tax, and thus not entitled to FTCs for the local tax, because only the borrower was legally obligated to withhold it. We review the legal conclusions of the tax court de novo. *E.g.*, *Sargent v. Commissioner*, 929 F.2d 1252, 1254 (8th Cir. 1991).

We reject this argument as did the tax court below and the other courts which have addressed this question. *See Continental Illinois Corp. v. Commissioner*, 998 F.2d 513, 518-19 (7th Cir. 1993) (*Continental*), *cert. denied*, 114 S. Ct. 685 (1994); *Continental Illinois Corp. v. Commissioner*, 55 T.C.M. (CCH) 1325, 1330 (1988), *aff'd sub nom. Citizens & Southern Corp. v. Commissioner*, 919 F.2d 1492 (11th Cir. 1990) (per curiam); *Nissho Iwai American Corp. v. Commissioner*, 89 T.C. 765, 773-74 (1987) (*Nissho*). It is a well-settled principle under United States tax law that the person obligated to pay the tax is not necessarily the same person to whom legal liability attaches. *Nissho*, 89 T.C. at 773. *Nissho*, which the tax court here cites, compared the Brazilian system to the wage withholding system in the United States under which employees remain legally liable for income taxes, although the employer is the person obligated to withhold the tax and pay the tax to the government. *Id.* Similarly, the Brazilian borrower is only charged with an administrative function. As explained, under Brazilian law, interest paid to foreign lenders like Norwest is subject to the local tax. The Brazilian borrower is required to withhold the local tax from each interest payment. *Id.* at 774, *citing Gleason Works v. Commissioner*, 58 T.C. 464, 478 (1972) (noting that liability for taxes "does not rest upon a search for the person from whom the tax is collectible but rather for the person upon whom the tax is imposed"). The Commissioner argues that in Brazil only borrowers

have an enforceable legal obligation because withholding is the exclusive means of collection. The Commissioner's argument is unduly formalistic because Brazilian banking authorities will not allow the Brazilian borrower to buy foreign currency to pay interest to foreign lenders without proof it has withheld and paid the local tax. The lender thus could not escape liability and the absence of a law specifically applying to the lender is irrelevant. *See Continental*, 998 F.2d at 518. "[T]he [local] tax is 'paid' by the [foreign] lender even if the [Brazilian] borrower operates as [its] agent for payment and even if the [Brazilian government's] tax enforcement guns are trained on the agent [that is, the Brazilian borrower,] rather than on the principal [that is, the foreign lender]." *Id.* at 519. For the foregoing reasons, the Commissioner's cross-appeal is denied.

B. *Norwest's Appeal—Pecuniary Benefit Program*

During the years at issue, Temp. Treas. Reg. § 4.901-2(f)(3)(i)(A), which is no longer in force, disallowed taxpayers from claiming as a FTC amounts "used directly or indirectly by the [foreign] country to provide a subsidy by any means (such as through a refund or credit) to the taxpayer." Temp. Treas. Reg. § 4.901-2(f)(3)(ii)(B) further provided that "[a] foreign country is considered to provide a subsidy" to the taxpayer if (1) the foreign country provides a subsidy to another person with whom the taxpayer "[e]ngages in a business transaction" and (2) the subsidy received by such other person is determined directly or indirectly "by reference to the amount of income tax, or the base used to compute the income tax" imposed on the taxpayer. Subsection § 4.901-2(g)(1) provided in part that "[i]ncome tax is paid or accrued by or on behalf of a person if foreign law imposes legal liability for income tax on that person and income tax is paid or accrued under paragraph (f) of this section." In other words, the regulation disallows a FTC to the extent that the foreign tax is used to subsidize the taxpayer. *See Continental*, 998 F.2d at 519. The regulation has been codified essentially without any change in

wording in 26 U.S.C. § 901(i).[3] The tax court below held that payments under Brazil's pecuniary benefit program met both requirements of § 4.901-2(f)(3)(ii)(B) and thus constituted a subsidy to Norwest under § 4.901-2(f)(3)(i)(A).

Norwest and the *amici* make related arguments challenging the regulation. Norwest and *amicus* Bankers Trust argue that

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[3] Title 26 U.S.C.A. § 901 (West Supp. 1995) provides in part:

> **(a) Allowance of credit.--** If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960...
>
> **(b) Amount allowed.--** Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):
>
> > **(1) Citizens and domestic corporations.--** In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States;...
>
> . . . .
>
> **(i) Taxes used to provide subsidies.--** Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent--
>
> > **(1)** the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and
> >
> > **(2)** such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

Temp. Treas. Reg. § 4.901-2(f)(3)(ii)(B) is inconsistent with the language of § 901, which allows a credit for taxes "paid or accrued" to the foreign government, and inconsistent with the purpose of 26 U.S.C. § 901, which is to prevent double taxation. They argue that the regulation imposes double taxation upon Norwest on account of a subsidy from which Norwest received neither a decrease in its taxes nor an economic benefit. Norwest and *amicus* First Chicago Corporation (First Chicago) argue that the use of the word "considered" in § 4.901-2(f)(3)(ii) indicates that the regulation only creates a rebuttable presumption that a payment qualifies as a subsidy under the general rule set out in Temp. Treas. Reg. § 4.901-2(f)(3)(i)(A). This presumption, they argue, is rebutted if the taxpayer can show that it received no economic benefit from the subsidy. To the extent the taxpayer received no economic benefit, then the payment would not be a subsidy and would not reduce the FTC. The Commissioner disagrees, arguing that the plain language of the regulation supports no such rebuttable presumption.

We note that the Commissioner's interpretations of treasury regulations are entitled to substantial deference. *Jewett v. Commissioner*, 455 U.S. 305, 318 (1982); *see also Ford Motor Credit Co. v. Milhollin*, 444 U.S. 555, 566 (1980). Courts customarily defer to a treasury regulation that implements the congressional mandate in some reasonable manner. *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 560-61 (1991) (citing *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 476-77 (1979) (*National Muffler*) (regulation may have particular force if substantially contemporaneous construction of statute by those presumed to have been aware of Congressional intent)); *see also Chevron, U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 843 (1984). Courts should not overrule such a regulation "except for weighty reasons." *Bingler v. Johnson*, 394 U.S. 741, 750 (1969) (citing *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948)). In *National Muffler*, the Supreme Court set out factors to determine the reasonableness of a treasury regulation. These factors include whether "the regulation harmonizes with the plain language of the statute, its origin, and its purpose," and "the consistency of the Commissioner's interpretation." 440 U.S. at 477.

We think the regulation reasonably interprets the statutory language "paid or accrued" to mean circumstances in which the foreign tax, here the local tax on interest payments made to foreign lenders, has in substance been paid. The regulation reasonably views the payment of the local tax and the receipt of the pecuniary benefit or subsidy together in order to determine the amount of foreign taxes creditable for purposes of 26 U.S.C. § 901. *See Nissho*, 89 T.C. at 777 (viewing payment of tax and receipt of subsidy as "in lockstep"). This interpretation is also consistent with the intent of Congress to reduce international double taxation. Norwest can claim a foreign tax credit for the amount of Brazilian taxes it paid, that is, as discussed below, the amount of the local tax reduced by the pecuniary benefit or subsidy. Norwest is not subject to double taxation because the pecuniary benefit or subsidy was not paid to the Brazilian government. This is because the pecuniary benefit or subsidy operated as a rebate of most of the local tax, in effect reducing the tax rate by 80%, from 25% to 5%. *See Continental*, 998 F.2d at 519.

In addition, we agree with the tax court that the degree of the actual economic benefit[4] conferred upon the taxpayer by the

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[4] As noted in *Continental Illinois Corp. v. Commissioner*, 998 F.2d 513, 519-20 (7th Cir. 1993) (Posner, J.) (*citing* Joseph Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, & Creditable Taxes*, 39 Tax L. Rev. 227, 244-47 (1984); 1 Joseph Isenbergh, International Taxation ¶ 18.10.2, at 507-8 (1990)), *cert. denied*, 114 S. Ct. 685 (1994), the regulation avoids the necessity of economic benefit analysis by adopting a "bright line" definition of subsidy for purposes of entitlement to the foreign tax credit:

> "Subsidy" is a tricky concept. It is by no means clear that the Brazilian tax rebate [referring to the pecuniary benefit program] subsidized, in the sense of conferring an actual benefit upon, American net lenders like Continental [and Norwest]. Indeed, insofar as the interest rate had been fixed in the loan contract before the rebate was instituted, only the borrowers benefited; for we noted at the outset that the difference between a net and a gross loan is that a net loan allocates the risk and

(continued...)

subsidy is not relevant under the regulation. The regulation defines certain amounts of tax as subsidies without reference to actual economic benefit. "The regulation is clear as a bell, and its validity [on this point] cannot be seriously questioned...." *Id.* at 520.

> The IRS regulation...elides a difficult factual inquiry [into the extent of the taxpayer's economic benefit] by deeming the taxpayer subsidized if the [foreign] country subsidizes a person with whom the taxpayer "engages in a business transaction," provided the subsidy "is determined directly or indirectly by reference to the amount of income tax...imposed by the country on [that] person with respect to such transaction." ...Just as the IRS must be given leeway in deciding what proof to require that a tax has actually been paid, so it must be given leeway in deciding when a rebate to a foreign business partner of a U.S.

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[4](...continued)
benefit of any change in the tax rate to the borrower because the lender's return is specified net of tax. Even if not frozen by the contract the interest rate might not rise by the amount of the subsidy. It is true that the subsidy would make the borrowers more eager to take out foreign loans and that an increase in demand usually results in an increase in price, but the increase in demand need not be proportionally equal to the increase in price and it would be tempered here by competition among the foreign lenders; also, Brazil imposed ceilings on interest rates. Figuring out who gets how much of the benefit of a subsidy is like figuring out who really pays a tax, since the nominal taxpayer has an incentive to shift it as best he can forward or backward. It all depends on contract terms and on conditions of demand and supply.

> ...The IRS can hardly be faulted for having chosen a bright-line approach in preference to interminable investigation of the mysteries of public finance, much as the latter approach might appeal to the legal, accounting, and economic-consulting communities.

> taxpayer should be deemed a subsidy to the taxpayer, disentitling [it] to a foreign tax credit.

Id. The reduction in the local tax rate constituted an indirect subsidy within the plain language of the regulation: it is provided to the Brazilian borrower that engaged in a business transaction with the taxpayer and is calculated as a specific percentage of the tax imposed on the payment to the taxpayer.

Amicus Bankers Trust also argues that the regulation is unreasonable because it reflects an abrupt shift in the Commissioner's position, citing *Rowan Cos. v. United States*, 452 U.S. 247, 263 (1981) (*Rowan*), where the Court refused to defer to "inconsistent and unexplained" interpretations propounded by the Commissioner. While such a shift in position can be relevant to determining reasonableness, it is not determinative. The Supreme Court has held that "it is well established that the Commissioner may change an earlier interpretation of the law." *Dickman v. Commissioner*, 465 U.S. 330, 343 (1984). *Rowan*, however, can be distinguished from the present case because the Commissioner's position in *Rowan* was also inconsistent with the Court's analysis of the language and congressional intent. 452 U.S. at 255-58. *Amicus* Bankers Trust advances other arguments addressing the reasonableness of the regulation, none of which we accept.[5] We hold that Temp. Treas. Reg. § 4-901-2(f) is valid and hold that the subsidies provided to borrowers under the pecuniary benefit program meet the requirements of § 4.901-2(f)(3)(ii)(B), and thus are indirect subsidies to Norwest. *See Continental*, 998 F.2d at 520. Accordingly, Norwest is not entitled to FTCs for those amounts.

We also hold that Norwest is not entitled to FTCs for amounts of the pecuniary benefit or subsidies allocated to repass

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[5] *Amicus* Bankers Trust also argues that Temp. Treas. Reg. § 4.901-2(f)(3) is unreasonable because it (1) does not represent a contemporaneous interpretation of the statute, (2) does not represent a long-standing interpretation of the statute, (3) is an interpretative regulation entitled to less deference, and (4) involves a permissible attempt to legislate.

borrowers. Norwest and *amicus* First Chicago argue that Temp. Treas. Reg. § 4.901-2(f)(3)(ii)(B) does not apply because repass borrowers are not parties to "a business transaction" with the foreign lender (the taxpayer). We agree with the Commissioner and the tax court that the transactions between the foreign lender and the primary borrower are separate from the transactions between the primary and repass borrowers. However, when the primary borrower made the interest payment to the foreign lender, it received the subsidy which it was required to pass along to the repass borrowers by Brazilian law. We agree with the Seventh Circuit that repass loans fall "within the letter as well as the spirit of the subsidy regulation." *Continental*, 998 F.2d at 520.

For the foregoing reasons,[6] the order of the tax court is affirmed and the cross-appeal is denied.

A True Copy:

Attest:

Clerk, U.S. Court of Appeals, Eighth Circuit

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[6] Because we decide this appeal on the basis of the regulations, we need not address Norwest's argument that the tax court erroneously evoked the "substance over form" doctrine.

APPENDIX B

UNITED STATES TAX COURT

NORWEST CORPORATION AND AFFILIATED COMPANIES, FORMERLY NORTHWEST BANCORPORATION AND AFFILIATED COMPANIES, NORWEST BANK FORT DODGE, N.A., FORMERLY FIRST NATIONAL BANK, AND NORWEST BANK MARION, N.A., FORMERLY FIRST NATIONAL BANK OF MARION, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 37288-86 Filed May 18, 1992.

David R. Brennan and *Walter A. Pickhardt*, for petitioner.
William G. Merkle, for respondent.

MEMORANDUM OPINION

JACOBS, *Judge*: Respondent determined deficiencies in the F deral income tax of Norwest Corporation and Affiliated Companies (Norwest), Norwest Bank Fort Dodge, N.A., formerly First National Bank, and Norwest Bank Marion, N.A., formerly First National Bank of Marion. The parties have resolved their differences with respect to these deficiencies.

In the petition, Norwest claimed an overpayment of tax based on its alleged entitlement to foreign tax credits for Brazilian withholding taxes on interest income which it received on net loans made to Brazilian borrowers. Pursuant to the terms of a net loan, the borrower is contractually obligated to pay all Brazilian taxes due on interest paid to the lender. During the years involved, the Brazilian borrowers received subsidies from the Brazilian Government equal to a percentage of the taxes withheld on the interest tendered.

The specific issues which we must decide are: (1) Whether any part of the Brazilian withholding taxes is a creditable foreign

tax under section 9.01;[1] and if so, then (2) whether the subsidies the Brazilian Government paid to Brazilian borrowers should reduce the amount of the foreign tax credit. These issues are the same as those we confronted in *First Chicago Corp., v. Commissioner*, T.C. Memo. 1991-44, the consolidated cases of *Continental Illinois Corp. v. Commissioner*, T.C. Memo. 1988-318, affd. without published opinion sub nom. *Citizens and Southern Corp. v. Commissioner*, 919 F.2d 1492 (11th Cir. 1990) (the *Continental Illinois* case), and *Nissho Iwai American Corp. v. Commissioner*, 89 T.C. 765 (1987). The amount of Brazilian foreign tax credits at issue is $398,318 for 1980 and $523,806 for 1982.

This case was submitted to the Court fully stipulated pursuant to Rule 122. Many of the facts stipulated are derived from the record in the *Continental Illinois* case. The stipulation of facts and attached exhibits are incorporated herein.

Background

Each petitioner's principal place of business was in Minneapolis, Minnesota, at the time the petition was filed.

Norwest is the parent company of a group of corporations which filed consolidated income tax returns for the years in issue. Norwest regularly made loans to borrowers located in foreign countries, including Brazil. It maintained a representative office in San Paulo, Brazil, but because of restrictions imposed by Brazilian law, the representative office did not enter into loan transactions but rather recommended them to Norwest's head office in Minneapolis.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Brazilian Regulation of Foreign Lending

Brazil imposed restrictions on the receipt and exchange of foreign currency. By law, the Banco Central do Brasil (Central Bank) registered and approved all loans from foreign lenders to Brazilian borrowers. Through the registration process, the Central Bank set the range of acceptable interest rates and periodically established the minimum repayment terms of loans. Once the Central Bank approved a loan, the lender remitted the proceeds in foreign currency to the borrower via a commercial bank in Brazil. The Brazilian bank converted the foreign currency into Brazilian currency by means of an exchange contract, whereby the borrower sold the foreign currency to the bank for Brazilian currency at the official exchange rate periodically set by the Central Bank.

The Brazilian borrower received a Certificate of Registration that enabled the borrower to effect payment of interest and principal in the foreign currency in which the loan was made. On each payment date, the borrower purchased foreign currency from a Brazilian bank at the official exchange rate. The Brazilian bank then tendered the foreign currency to the foreign lender.

Payment of the Withholding Tax

Brazilian law prohibited remittance of an interest payment to a foreign lender without proof of payment of the withholding tax on interest remitted abroad. Under Brazilian law, the borrower initiated payment of the withholding tax by submitting a Documento de Arrecadacao de Receitas Federais (DARF) and the accompanying tax payment to a commercial Brazilian bank. Any bank making an interest payment in foreign currency which was subject to Brazilian tax would require a completed DARF and payment of the tax as evidence that the proper amount of tax had been paid.[2]

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[2] The borrower prepared the DARF and delivered a copy of the DARF and the registration certificate to the Brazilian bank (or U.S. branch bank) handling the payment of interest through a foreign exchange contract. The bank recorded the amount of interest and tax on the Certificate of Registration and submitted the certificate, exchange

(continued...)

Thus, for net loans, payment of the Brazilian tax on interest remitted abroad occurred simultaneously with the payment of interest.

Institution of the Pecuniary Benefit

Under Decree-law 1,215, enacted May 4, 1972, the Brazilian Minister of Finance was given discretion to grant a reimbursement or reduction of, or exemption from, the withholding tax on interest provided that: (1) The borrower's costs were reduced; (2) the loan was of national interest; and (3) the loan complied with other conditions (such as minimum repayment terms) set forth by the Ministry of Finance.

Decree-law 1,351, which was enacted on October 24, 1974, authorized the National Monetary Council[3] to temporarily reduce the income tax on interest, commissions, and expenses remitted to persons residing or domiciled abroad. On the same date that Decree-law 1,351 was enacted (October 24, 1974), the Central Bank issued Resolution 305, which temporarily reduced the tax on interest, commissions, and expenses received on cash loans registered with the Central Bank from 25 percent to 5 percent.

Decree-law 1,411, enacted July 31, 1975, amended Decree-law 1,351 and allowed the National Monetary Council to: (1) Reduce the income tax on interest, commissions, and expenses remitted to persons resident or domiciled aborad, or (2) grant

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[2](...continued)
contract, and DARF to the Central Bank for approval. Upon approval by the Central Bank, the bank remitted the interest to the foreign lender and returned to the borrower a stamped copy of the DARF, the Certificate Registration (stamped), and a copy of the exchange contract. The borrower sent a copy of the DARF to the foreign lender which then had proof (the DARF) that the withholding tax was paid. The lender performed no act in Brazil for the collection of tax.

[3] The National Monetary Council is a Government agency responsible for economic programs. It acts through the Central Bank.

pecuniary benefits to Brazilian borrowers receiving loans in foreign currency.

On August 5, 1975, the Central Bank issued Resolution 334 which revoked Resolution 305, thereby reinstating the 25-percent tax on interest, commissions, and expenses paid on cash loans registered with the Central Bank.

Mechanics and Amount of the Pecuniary Benefit

On the same day that the 25-percent tax on interest was reinstated (i.e., August 5, 1975), the Central Bank issued Resolution 355, which provided that borrowers taking out foreign loans duly registered with the Central Bank would receive a pecuniary benefit equal to 85 percent of the tax paid on the interest, commissions, and expenses due on such loans.

Also on August 5, 1975, the Central Bank issued Circular 266, which provided in part that:

a. a DARF would be used for the payment of the 25-percent income tax on interest resulting from foreign currency loans;

b. on the date of payment, the banking establishment receiving the payment would, by means of a credit to the borrower's account, pay to the borrower the equivalent of 85 percent of the income tax; and

c. the banking establishment receiving the tax payment would debit its own account entitled "Pecuniary Benefit-D.L. 1,411," and would charge the total value of the pecuniary benefit against the Central Bank.

On July 26, 1979, the pecuniary benefit was reduced to 50 percent of the tax. On December 7, 1979, the pecuniary benefit was increased to 95 percent of the tax; on May 8, 1980, the pecuniary benefit was reduced to 40 percent of the tax; and on July 28, 1985, the pecuniary benefit was reduced to zero.

Resolution 63 Loans

Many Brazilian companies that needed working capital were not able to provide foreign lenders with adequate financial information or proper guarantees to obtain a loan. To provide Brazilian companies with the funds needed for their development, and in keeping with the Brazilian Government's efforts to develop the country's economy and generate foreign exchange, the Central Bank issued Resolution 63 on August 21, 1967.

Resolution 63 permitted certain Brazilian banks to borrow funds from abroad for the specific purpose of relending (repassing) the corresponding borrowed funds in Brazilian currency to Brazilian companies (repass borrowers). The charges paid by a repass borrower to a Brazilian bank were in the same proportion as the charges paid by the Brazilian bank to the foreign lender. The loan between the foreign lender and the Brazilian bank was independent of the loan between the Brazilian bank and the repass borrower. The foreign lender had no legal relationship with the repass borrower and in general did not know the repass borrower's identity.

Foreign loans which were repassed under Resolution 63 were subject to the same restrictions on the receipt and exchange of foreign currency as other foreign loans. Circular 266 provided that in the case of a Resolution 63 loan, the bank receiving the foreign loan was required to transfer the total value of the pecuniary benefit to the borrower receiving the repass funds, and in cases in which the foreign loan was transferred to several repass borrowers, the pecuniary benefit was transferred proportionally to each of such borrowers.

Details of Repass Lending Under Resolution 63

Generally, a foreign lender was concerned only with the credit risk of the Brazilian bank. The initiative to borrow foreign funds for lending to local companies under Resolution 63 was that of the Brazilian bank, which would repass loans if and when local borrowers were available. In making Resolution 63 loans to Brazilian banks, foreign lenders generally assumed that the

Brazilian bank would pass through its cost of funds (the cost of the foreign lender's loan) and charge a spread or commission to the repass borrower.

The Brazilian bank was allowed to charge its borrower only a repass commission. The repass commission was usually calculated as a set percentage per year of the principal balance of the repass loan. The amount of the repass commission was the same as the commission charged for other types of loans. During the years in issue, there was no limit on repass commissions, and the commission was as high as 10 percent, depending upon the individual repass borrower's credit.

Except for the term of the loan, all other financial conditions of the loan between the Brazilian bank and the repass borrower had to be the same as those between the foreign lender and the Brazilian bank. If the interest rate charged by the foreign lender to the Brazilian bank was net of the Brazilian withholding tax, then the interest rate payable by the repass borrower was likewise net of the Brazilian withholding tax. If the Brazilian bank was entitled to a pecuniary benefit, then it passed on such benefit to the repass borrower. The transfer of the pecuniary benefit from the Brazilian bank to the repass borrower reduced the repass borrower's cost of the repass loan, and thus encouraged foreign borrowing.

Beginning in 1974, Resolution 63 funds not utilized in repass operations could be deposited with Central Bank. When such funds were deposited, the Central Bank paid the interest on the foreign loan; and if there was a net loan involved, no withholding tax was paid with respect to the Central Bank's interest payment.

Brazilian Tax Law

The Brazilian tax system is divided into three types of authority: the Federal Constitution of Brazil (Federal Constitution), the National Tax Code, and ordinary Federal, State, and municipal legislation.

The Federal Constitution divides the authority to tax among the Federal Government, the States, and the municipalities of

Brazil. Pursuant to Article 21 of the Federal Constitution, the Federal Government has authority to impose all types of taxes, including a tax on income, except as otherwise granted by the Federal Constitution to the States or municipalities.

The National Tax Code establishes the parameters within which the taxing authority of the Federal Government, the States, and the municipalities may be exercised. It does not, in and of itself, create or impose any taxes.

Article 4 of the National Tax Code specifies that the legal nature of a tax is determined by its generating factor (that is, the taxable event); the name and other formal characteristics of the tax are irrelevant to the legal nature of the tax.

Article 113 of the National Tax Code divides tax obligations into principal and accessory obligations. The principal obligation is created by the taxable event, and has as its objective the payment of tax. The accessory obligation is derived from the tax legislation and has as its objective the performance of specific acts (e.g., maintaining books and records, filing returns) in the interest of collection of the tax. The taxable event which gives rise to the tax on income is the economic or legal availability of such income.

Under article 45 of the National Tax Code, the person entitled to "the economic or legal availability of income" is called the contribuente, or taxpayer. However, the status of the contribuente can be attributed to the holder of the assets producing the income or earnings. In addition, the source making payment of the income can be liable for the tax if such source is required by law to withhold and pay such tax to the Brazilian Treasury.

Under article 121 of the National Tax Code, the person obligated to make the payment of the tax is called the "passive subject" of the principal obligation. The passive subject of the principal obligation is either: (1) The contribuente, when he has a personal and direct relationship with the taxable event or (2) the responsavel (responsible or person liable) when, without having the status of a contribuente, he has an obligation to pay the tax by an express provision of law.

Article 122 of the National Tax Code defines the passive subject of an accessory obligation as the person obligated to perform the duties which comprise the accessory obligation.

Article 123 of the National Tax Code specifies that, except as otherwise provided by law, private agreements concerning the liability to pay taxes are not binding on the public treasury.

Article 128 of the National Tax Code provides that the liability for a tax claim may be assigned to a third party who is related to the taxable event which gives rise to the tax obligation.

Since 1943, Brazilian Federal legislation has provided for a withholding tax imposed on interest paid by Brazilian borrowers to foreign entities, at the following rates:

Rate	Years
10%	1944-1947
15%	1948-1954
20%	1955-1958
25%	1959-1974
5%	1974-1975
25%	1975-Present

Norwest's Resolution 63 Lending Practices

Norwest's lending operations in Brazil were a "wholesale" operation. In making Resolution 63 loans to a Brazilian bank, Norwest contracted only with the Brazilian bank and not with the repass borrower. Thus, Norwest's credit decisions were based upon the credit worthiness of the Brazilian bank and not upon that of the repass borrower.

Position of Parties

All of the loans at issue were net loans, and at all times the borrower (or repass borrower) received a subsidy from the Brazilian Government equal to a percentage of the taxes withheld.

For tax purposes, Norwest grossed up[4] the amount of interest Norwest received with regard to its net loans and claimed a foreign tax credit for the 25-percent withholding tax. Respondent argues that Norwest was not entitled to any foreign tax credits claimed with respect to Brazilian withholding taxes which Brazilian borrowers paid on Norwest's net loans on the theory that Norwest was not legally liable for such withholding taxes. Respondent also argues that the pecuniary benefits which the Brazilian Government paid reduced Norwest's payment of Brazilian tax, and correspondingly decreased Norwest's interest income.

Legal Analysis

Section 901 allows a domestic corporation to claim as a credit against its Federal income tax (subject to certain limitations not applicable herein) the amount of any income taxes which such corporation pays or accrues to a foreign country. The regulations make it clear that a credit under section 901 is available for foreign taxes paid on behalf of a domestic corporation. Sec. 4.901-2(a), Temporary Income Tax Regs., 45 Fed. Reg. 75648 (Nov. 17, 1980).[5]

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[4] The withholding tax is computed as a percentage of the lender's gross income, and thus when a Brazilian borrower discharges a U.S. lender's tax obligation, a gross-up adjustment is necessary to determine the lender's gross income. For example, if the borrower was required to pay the foreign lender $9 in interest net of Brazilian tax, and the tax rate was 25 percent, then the amount of gross income would be $12 [$9 net interest received ÷ (1.25% tax rate)] so that the 25-percent withholding tax would result in a tax payment of $3 ($12 gross income X 25% tax = $3 tax payment).

[5] In November 1980, the Internal Revenue Service issued temporary regulations which set forth requirements for, and limitations on, the amount of foreign tax credit. These temporary regulations, secs. 4.901-2 and 4.903-1, 45 Fed. Reg. 75648-75658 (Nov. 17, 1980), generally were made applicable to taxable years ending after June 15, 1979. Final regulations under sec. 901 were made effective for taxable years beginning after Nov. 14, 1983. Sec. 1.901-2(h)(1), Income Tax Regs.

A foreign tax is creditable only if the taxpayer is legally liable for the tax. Sec. 4.901-2(g), Temporary Income Tax Regs., 45 Fed. Reg. 75655 (Nov. 17, 1980). Respondent claims that only the Brazilian borrower was legally liable for the Brazilian withholding tax on interest remitted abroad. Therefore, respondent argues, Norwest was not legally liable for the Brazilian withholding tax, and thus such tax is not creditable under section 901.

For the same reasons expressed in *Nissho Iwai American Corp. v. Commissioner*, 89 T.C. 765 (1987), and in *Continental Illinois Corp. v. Commissioner*, T.C. Memo. 1988-318, affd. without published opinion sub nom. *Citizens and Southern Corp. v. Commissioner*, 900 F.2d 266 (11th Cir. 1990), which need not be repeated here, we hold that Norwest is liable for the Brazilian withholding tax and hence is entitled to a foreign tax credit. See also *First Chicago Corp. v. Commissioner*, T.C. Memo. 1991-44.

We now turn to whether the pecuniary benefits or subsidies which Norwest's borrowers received from the Brazilian Government reduce the amount of foreign tax creditable under section 901. Respondent contends that if Norwest was legally liable for the Brazilian tax, then the amount of the creditable tax must be reduced by the subsidies Norwest's borrowers received. The holdings in *Nissho Iwai American Corp. v. Commissioner*, *supra*, and in *Continental Illinois Corp. v. Commissioner*, *supra*, control the resolution of this issue. See also *First Chicago Corp. v. Commissioner*, *supra*.

As we said in *Nissho Iwai*:

> payment of the tax and receipt of the subsidy are in lockstep. Common sense dictates that payment of the tax and receipt of the subsidy be viewed together in determining the amount of foreign taxes creditable for purposes of section 901. If we accept payment of the Brazilian tax as one transaction and receipt of the subsidy as another, we would ignore the true unity of the transaction and elevate form over substance; this we shall not do. [89 T.C. at 777.]

In *Continental Illinois*, we explained that:

> We believe that the 1975 pecuniary benefit legislation was devised to maintain for Brazilian net loan borrowers the economic benefits of the 1974 withholding tax reduction from 25 to 5 percent while restoring to foreign lenders the foreign tax credit benefits of a withholding tax rate of 25 percent. In the context of net loans, the 1975 pecuniary benefit legislation had the same economic effect as the 1974 tax reduction on both Brazilian borrowers and the Brazilian Treasury. Nor did the 1975 pecuniary benefit legislation change the pre-tax (U.S.) economic status of petitioners and other U.S. lenders with net loans. However, by providing inflated foreign tax credits for petitioners and other U.S. lenders, the 1975 pecuniary benefit legislation allowed petitioners and other U.S. lenders to benefit taxwise at the expense of the U.S. Treasury.
>
> The purpose of the foreign tax credit is to reduce international double taxation. Here, disallowance of the pecuniary benefit portion of the tax does not subject petitioners to double taxation because the pecuniary benefit portion was not paid to the Brazilian Treasury. Following the enactment of the 1975 pecuniary benefit legislation, the Brazilian tax rate was in reality 5 percent, not 25 percent. [T.C. memo. 1988-318; citations omitted.]

Norwest argues that our conclusion that Brazil enacted its pecuniary benefit law to inflate foreign tax credits is contrary to the act of state doctrine. We disagree.

The act of state doctrine shares with the doctrine of sovereign immunity a respect for the acts of a sovereign state. The act of state doctrine precludes a court from declaring invalid the actions taken by another government within its own territory. *W.S. Kirkpatrick & Co. v. Environmental Tectonics Corp. International*, 493 U.S. 400, ____, 110 S.Ct. 701, 704-707 (1990); *Callejo v. Bancomer, S.A.*, 764 F.2d 1101, 1112-1114 (5th Cir. 1985).

In *Continental Illinois*, we determined that for U.S. foreign tax credit purposes, the pecuniary benefit portion of the Brazilian withholding tax is not creditable. We did not declare invalid the Brazilian pecuniary benefit legislation. Nor do we do so here. Thus, the act of state doctrine is inapplicable. Consistent with our prior holdings, we hold that the subsidies Brazil paid to Brazilian borrowers herein reduce the amount of Norwest's foreign tax credit.

Finally, Norwest argues that the subsidies which Brazilian banks passed through to repass borrowers in Resolution 63 lending transactions should not reduce its foreign tax credit. Section 4.901-2(f), Temporary Income Tax Regs., 45 Fed. Reg. 75653 (Nov. 17, 1980), provides:

> (f) Amount of income tax paid or accrued — (1) In general. A credit is allowed under section 901 for the amount of income tax (within the meaning of section 4.901-2(a)(1)) that is paid or accrued to a foreign country, subject to the provisions of this paragraph (f). ***
>
> * * * * * * *
>
> (3) Subsidies—(i) General rule. An amount is not income tax paid or accrued to a foreign country to the extent that —
>
> (A) The amount is used directly or indirectly by the country to provide a subsidy by any means (such as through a refund or credit) to the taxpayer; and
>
> (B) The subsidy is determined directly or indirectly by reference to the amount of income tax, or the base used to compute the income tax, imposed by the country on the taxpayer.
>
> (ii) Indirect subsidies. A foreign country is considered to provide a subsidy to a person if the country provides a subsidy to another person that —
>
> * * * * * * *

(B) Engages in a business transaction with the first person, but only if the subsidy received by such other person is determined directly or indirectly by reference to the amount of income tax, or the base used to compute the income tax, imposed by the country on the first person with respect to such transaction.

In a Resolution 63 loan, there are two different agreements: one between the foreign lender and the Brazilian bank and another between the Brazilian bank and the repass borrower. Albeit the Brazilian bank borrowed from the foreign lender in order to repass such borrowed funds to the repass borrower, the foreign lender had no legal relationship with the repass borrower, and the loan to the Brazilian bank was based solely on the Brazilian bank's credit risk. In fact, the foreign bank typically did not even know the identity of the repass borrower.

Although the Brazilian bank transferred a pro rata portion of the subsidy to which it was entitled to the repass borrower, it did so because the Brazilian bank was allowed to charge the borrower only a repass commission. All other financial conditions of the loan between the Brazilian bank and the repass borrower had to be the same as those between the foreign lender and the Brazilian bank. Because the subsidy reduced the Brazilian bank's costs, the Brazilian bank was required to pass such savings on to the repass borrower.

Both the payment of the withholding tax and the repass borrower's receipt of the subsidy were inextricably linked to the transaction between the foreign lender and the Brazilian bank. Hence, the provisions of section 4.901-2(f)(3)(ii)(B), Temporary Income Tax Regs., *supra*, are applicable to Resolution 63 loans, and the subsidies paid to repass borrowers reduce Norwest's foreign tax credit. See *Continental Illinois Corp. v. Commissioner*, *supra*.

To reflect the foregoing and the concessions of the parties,

Decision will be entered under Rule 155.

APPENDIX C

UNITED STATES TAX COURT

NORWEST CORPORATION AND AFFILIATED COMPANIES, FORMERLY NORTHWEST BANCORPORATION AND AFFILIATED COMPANIES, NORWEST BANK FORT DODGE, N.A., FORMERLY FIRST NATIONAL BANK, AND NORWEST BANK MARION, N.A., FORMERLY FIRST NATIONAL BANK OF MARION, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 37288-86

ORDER

On May 18, 1992, the Court rendered a Memorandum Opinion (T.C. Memo. 1992-282) in this case. On June 11, 1992, respondent filed a Motion for Reconsideration of Findings of Fact and Opinion requesting that the Court reconsider the findings of fact and opinion regarding the amounts in dispute in the opinion issued. The respondent states that at the top of page 3 of the opinion, the Court incorrectly states that "[t]he amount of Brazilian foreign tax credits at issue is $398,318 for 1980 and $523,806 for 1982." The correct amount of Brazilian foreign tax credits in dispute in this case is $396,317.56 for 1980 and $524,779.62 for 1982, with respect to the legal liability issue, and $396,317.56 for 1980 and $524,161.49 for 1982, with respect to the pecuniary benefit issue. The parties had incorrectly stipulated the amounts stated in the opinion. These erroneous amounts were based upon an earlier version of an exhibit which was subsequently revised. The premises considered, it is

ORDERED that respondent's Motion for Reconsideration of Findings of Fact and Opinion is granted, in part, in that the Memorandum Opinion (T.C. Memo. 1992-282, filed May 18, 1992, is amended at page 3, line 1, by deleting the sentence "The amount of Brazilian foreign tax credits at issue is $398,318 for 1980 and $523,806 for 1982." and replacing it with "The amount

of Brazilian foreign tax credits at issue is $396,317.56 for 1980 and $524,779.62 with respect to the legal liability issue ($524,161.49 with respect to the pecuniary benefit issue) for 1982." It is further

ORDERED that the Memorandum Opinion in all other respects remains unchanged.

DATED: Washington, D.C.
June 15, 1992

Julian I. Jacobs
Judge

APPENDIX D

UNITED STATES TAX COURT

NORWEST CORPORATION AND AFFILIATED COMPANIES, FORMERLY NORTHWEST BANCORPORATION AND AFFILIATED COMPANIES, NORWEST BANK FORT DODGE, N.A., FORMERLY FIRST NATIONAL BANK, AND NORWEST BANK MARION, N.A., FORMERLY FIRST NATIONAL BANK OF MARION, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 37288-86

DECISION

Pursuant to the opinion of the Court filed May 18, 1992, as amended by order of the Court, dated June 15, 1992, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That for the petitioners, Norwest Corporation and Affiliated Companies, there is an overpayment in income tax for the taxable year 1972 in the amount of $1,163,885, which amount was paid on March 15, 1973, and for which amount a claim for refund could have been filed, under the provisions of I.R.C. § 6511(d)(2), on June 17, 1986, the date of the mailing of the notice of deficiency;

That for the petitioners, Norwest Corporation and Affiliated Companies, there is an overpayment in income tax for the taxable year 1980 in the amount of $670,545, of which amount $358,888 was paid on March 15, 1981 for which amount a claim for refund was filed on April 17, 1984, which was within the period provided by I.R.C. § 6511(c), and which claim had not been disallowed before the date of the mailing of the notice of deficiency; and $311,657 was paid on March 15, 1981, for which amount a claim for refund could have been filed, under the provisions of I.R.C. §

6511(c), on June 17, 1986, the date of the mailing of the notice of deficiency;

That for the petitioners, Norwest Corporation and Affiliated Companies, there is a deficiency in income tax due from the petitioners for the taxable year 1982 in the amount of $795,913;

That for the petitioner, Norwest Bank of Marion, N.A., there is an overpayment in income tax for the taxable year 1971 in the amount of $190, which amount was paid on March 15, 1972, and for which amount a claim for refund could have been filed, under the provisions of I.R.C. § 6511(d)(2), on June 17, 1986, the date of the mailing of the notice of deficiency;

That for the petitioner, Norwest Bank of Marion, N.A., there is an overpayment in income tax for the taxable year 1974 in the amount of $6,644, which amount was paid on March 15, 1975, and for which amount a claim for refund could have been filed, under the provisions of I.R.C. § 6511(d)(2), on June 17, 1986, the date of the mailing of the notice of deficiency;

That for the petitioner, Norwest Bank of Marion, N.A., there is no deficiency in income tax due from or overpayment due to the petitioner for the taxable years 1970 or 1973; and

That for the petitioner, Norwest Bank Fort Dodge, N.A., there is no deficiency in income tax due from or overpayment due to the petitioner for the taxable year 1972.

Judge.

Entered:

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

It is further stipulated that, effective upon the entry of this decision by the Court, petitioners waive the restrictions contained in I.R.C. § 6213(a) prohibiting assessment and collection of the deficiency (plus statutory interest) until the decision of the Tax Court becomes final.

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APPENDIX E

RELEVANT STATUTORY AND REGULATORY PROVISIONS

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 901. Taxes of Foreign Countries and of Possessions of United States.

(a) *Allowance of credit.*—If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of Section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against the tax imposed by section 56 (relating to corporate minimum tax), against the tax imposed for the taxable year under section 72(m)(5)(B) (relating to 10 percent tax on premature distributions to owner-employees) section 72(g)(1) (relating to 5-percent tax on premature distributions under annuity contracts) against the tax imposed by section 402(e) (relating to tax on lump sum distributions), against the tax imposed for the taxable year by section 408(f) (relating to additional tax on income from certain retirement accounts), against the tax imposed by section 531 (relating to the tax on accumulated earnings), against the additional tax imposed for the taxable year under section 1351 (relating to the recoveries of foreign expropriation losses), or against the personal holding company tax imposed by section 541.

(b) *Amount Allowed.*—Subject to the limitation of section 904, the following amounts shall be allowed as the credit under section (a):

(1) *Citizens and domestic corporations.*—In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess

profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States.

Internal Revenue Code of 1986 (26 U.S.C.):

SEC. 901(i). This section **only** applies to tax years after 1986.

(i) Taxes used to provide subsidies.—Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent—

(1) the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and

(2) such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

Temporary Treasury Regulations:

§ 4.901-2 [Temporary Regulation prescribed by TD 7739, approved Nov. 5, 1980 and filed Nov. 12, 1980]

* * *

(f) *Amount of income tax paid or accrued.*—(1) In general. A credit is allowed under section 901 for the amount of income tax (within the meaning of § 4.901-2(a)(1)) that is paid or accrued to a foreign country, subject to the provisions of this paragraph (f). The amount of income tax paid or accrued is determined separately for each taxpayer.

(2) *Refunds.* An amount is not income tax paid or accrued to a foreign country to the extent that it is reasonably certain that the amount will be refunded. It is not reasonably certain that an

amount will be refunded if the amount is a reasonably approximation of final income tax liability to the foreign country.

(3) *Subsidies.*—

(i) *General Rule.* An amount is not income tax paid or accrued to a foreign country to the extent that—

(A) The amount is used directly or indirectly by the country to provide a subsidy by any means (such as through a refund or credit) to the taxpayer; and

(B) The subsidy is determined directly or indirectly by reference to the amount of income tax, or the base used to compute the income tax, imposed by the country on the taxpayer.

(ii) *Indirect subsidies.* A foreign country is considered to provide a subsidy to a person if the country provides a subsidy to another person that—

(A) Is owned or controlled, directly or indirectly, by the same interests that own or control, directly or indirectly, the first person; or

(B) Engages in a business transaction with the first person, but only if the subsidy received by such other person is determined directly or indirectly by reference to the amount of income tax, or the base used to compute the income tax, imposed by the country on the first person with respect to such transaction.

* * *

(g) *Taxpayer*—(1) *In general.* Income tax is paid or accrued by or on behalf of a person if foreign law imposes legal liability for income tax on that person and income tax is paid or accrued under paragraph (f) of this section.

* * *

(i) *Effective date.* This section shall apply to taxable years ending after June 15, 1979, unless the taxpayer chooses to apply this section to taxable years ending on or before such date. If a revenue ruling in effect on November 14, 1980 is inconsistent with this section, then, notwithstanding this section, a taxpayer may choose to apply such ruling for any taxable year ending on or before December 31, 1980.

Supreme Court, U.S.
FILED
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No. 95-1284

In the Supreme Court of the United States

OCTOBER TERM, 1995

NORWEST CORPORATION AND AFFILIATED COMPANIES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether Section 4.901-2(f)(3)(ii) of the Temporary Treasury Regulations, 26 C.F.R. 4.901-2(f)(3)(ii), is valid.

2. If Section 4.901-2(f)(3)(ii) is valid, whether the amount of Brazilian taxes nominally withheld from interest paid to petitioner by Brazilian borrowers, but then rebated by Brazil to those borrowers, is an indirect subsidy within the meaning of the regulation and thus does not constitute a tax "paid or accrued" to Brazil for which a foreign tax credit is available under Section 901 of the Internal Revenue Code, 26 U.S.C. 901.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statute and regulation involved	2
Statement	2
Argument	5
Conclusion	16

TABLE OF AUTHORITIES

Cases:

Chevron U.S.A. Inc. v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)	7
Chicago, B. & Q. R.R. v. *United States*, 455 F.2d 993 (Ct. Cl. 1972), rev'd on other grounds, 412 U.S. 401 (1973)	12
Continental Illinois Corp. v. *Commissioner*, 998 F.2d 513 (7th Cir. 1993), cert. denied, 114 S. Ct. 685 (1994)	5, 6, 7, 8, 9, 10
Dickman v. *Commissioner*, 465 U.S. 330 (1984)	12
Dixon v. *United States*, 381 U.S. 68 (1965)	12
Hillsboro National Bank v. *Commissioner*, 460 U.S. 370 (1983)	15
Missouri-Illinois R.R. v. *United States*, 381 F.2d 1001 (Ct. Cl. 1967)	12
Missouri Pac. R.R. v. *United States*:	
301 F. Supp 839 (E.D. Mo. 1967), aff'd in part and rev'd in part on other grounds, 411 F.2d 327 (8th Cir. 1969), cert. denied, 396 U.S. 1037 (1970)	12
497 F.2d 1386 (Ct. Cl. 1974)	12
National Muffler Dealers Ass'n v. *United States*, 440 U.S. 472 (1979)	7
Nissho Iwai American Corp. v. *Commissioner*, 89 T.C. 765 (1987)	13

Case—Continued: Page

Rowan Cos. v. *United States*, 452 U.S. 247 (1981) 7

Statutes and regulations:

Internal Revenue Code (26 U.S.C.):
§ 164(e) 15
§ 164(e)(1) 15
§ 164(e)(2) 15
§ 901 ..... 2, 6, 7, 10, 13, 15, 16
§ 901(b)(1) 6
§ 901(i) 6, 12, 16
§ 6110(j)(3) 11
Tax Reform Act of 1986, Pub. L. No. 99-514, § 1204(a), 100 Stat. 2532 12
26 C.F.R. (1981):
Section 4.901-2 ..... 2, 14
Section 4.901-2(f) 5, 6
Section 4.901-2(f)(2) 6, 8
Section 4.901-2(f)(3) 14
Section 4.901-2(f)(3)(i) 6, 8
Section 4.901-2(f)(3)(ii) 5, 6, 7, 8, 9, 10

Miscellaneous:

H.R. Rep. No. 426, 99th Cong., 1st Sess. (1985) 12
S. Rep. No. 313, 99th Cong., 2d Sess. (1986) 12
T.D. 7739, 1981-1 C.B. 396 14

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-11a) is reported at 69 F.3d 1404. The opinion of the Tax Court (Pet. App. 12a-25a) is reported at 63 T.C.M. (CCH) 3023.

JURISDICTION

The judgment of the court of appeals was entered on November 14, 1995. The petition for a writ of certiorari was filed on February 12, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE AND REGULATION INVOLVED

The relevant portions of Section 901 of the Internal Revenue Code, 26 U.S.C. 901, and of Section 4.901-2 of the Temporary Treasury Regulations, 26 C.F.R. 4.901-2 (1981), are set forth at Pet. App. 31a-34a.

STATEMENT

1. During the years in issue, Norwest Corporation and various affiliated lenders (collectively referred to as "petitioners") made loans to borrowers located in Brazil (Pet. App. 2a, 13a). The loans were made on a net quoted basis—that is, the borrowers (i) agreed to pay petitioners a specified interest rate on the loan and, in addition, (ii) agreed to pay directly to Brazil, on behalf of petitioners, any taxes imposed by Brazil on such interest payments (*id.* at 12a, 20a).

Since 1943, the Brazilian federal government has imposed a tax, which is withheld at the source, on interest remitted to foreign lenders. During the years in issue, the nominal rate of the tax was 25 percent (Pet. App. 20a). Brazilian law required a "gross-up" in calculating the amount of this tax imposed on the interest paid on net loans. If, for example, the rate of interest on a net loan were 12 percent, the tax would be computed as though the interest rate were 16 percent, so that 4 percent (*i.e.*, 25 percent of the "gross" rate of interest) would be "withheld" when the 12-percent net interest was remitted to the foreign lender (*id.* at 21a n.4).

Some of petitioners' loans were made to Brazilian banks that, in turn, made "repass" loans under Resolution 63 of the Brazilian Central Bank. That Resolution permitted certain Brazilian banks to borrow funds from abroad for the purpose of relending those funds to smaller Brazilian borrowers who

lacked access to international financial markets. The terms of Resolution 63 loans (as well as other loans to Brazilian borrowers from foreign lenders) were subject to regulation by the Brazilian government. The borrowing banks could relend, or "repass," the borrowed funds to domestic companies (repass borrowers) for shorter terms and smaller amounts than the direct foreign borrowings. There was no direct legal relationship between the foreign lender and the repass borrower in a Resolution 63 transaction, for the loan agreement between the foreign lender and the borrowing bank was independent of the loan agreement between the borrowing bank and the repass borrower. The borrowing bank, and not the repass borrower, was responsible for paying the interest to the foreign lender and for paying the taxes imposed by Brazil on that interest. The terms of repass loans, however, required each repass borrower to pay (i) an amount equal to its pro-rata share of the costs (interest *plus* tax) of the direct foreign borrowing from which the repass loan was made and (ii) a repass commission to the Brazilian bank (Pet. App. 3a, 17a-18a).

In August, 1975, Brazil instituted the "pecuniary benefit" program. Under this program, Brazilian borrowers that paid interest to foreign lenders would receive a "pecuniary benefit," or subsidy, that reduced by 85 percent the amount of the tax to be paid on the interest due on the loan (Pet. App. 15a-16a). [1] In Resolution 63 transactions, the borrowing bank was

---

[1] The amount of the pecuniary benefit was reduced to 50 percent of the tax in July, 1979, increased to 95 percent of the tax in December, 1979, reduced to 40 percent of the tax in May, 1980, and reduced to zero in July, 1985 (Pet. App. 16a).

required immediately to pass the cost reduction resulting from the "pecuniary benefit" on to its repass borrowers (*id.* at 18a, 25a). The amount of the "pecuniary benefit" was credited to the repass borrower's account on the same day that the remaining portion of the tax was withheld and paid to Brazil (*id.* at 16a).

In determining their United States income tax liability for the years in issue, petitioners took the position that they were entitled to foreign tax credits for the entire amount of the Brazilian taxes incurred with respect to interest payments, including the amounts that Brazil returned to borrowers as a "pecuniary benefit." The amount of the credits claimed by petitioners was $396,317 for 1980 and $524,161 for 1982 (Pet. App. 3a, 13a, 21a, 26a-27a). The Commissioner disallowed petitioners' claims for foreign tax credits with respect to the amounts that Brazil rebated to Brazilian borrowers; the Commissioner also correspondingly decreased the amount by which petitioners had "grossed-up" their interest income (*id.* at 21a).

2. Petitioners sought Tax Court review of the Commissioner's determinations. The Tax Court agreed with the Commissioner, however, that petitioners were not entitled to a foreign tax credit for the amounts that Brazil rebated to Brazilian borrowers as a "pecuniary benefit." The court explained that the rebated amounts—which were collected by Brazil from, and then returned by Brazil to, Brazilian borrowers—did not, in substance, represent taxes that petitioners paid to Brazil (Pet. App. 22a-25a). The court also concluded (*id.* at 24a-25a) that this rebate of the tax to the Brazilian borrowers who had remitted it in the first place represented an indirect

subsidy to the business being conducted by petitioners and therefore did not qualify as a tax paid to Brazil under the applicable Treasury regulation (26 C.F.R. 4.901-2(f)).

3 The court of appeals affirmed on the second of the Tax Court's two rationales (Pet. App. 1a-11a). The court relied on the regulation that was in effect during the years in issue and on the Seventh Circuit's decision in *Continental Illinois Corp* v. *Commissioner*, 998 F.2d 513, 518-519 (7th Cir. 1993), cert. denied, 114 S. Ct. 685 (1994), which relied upon the same regulation in deciding the identical issue. Under that regulation, an amount is not to be treated as a tax paid or accrued to a foreign country (and is therefore not eligible for the foreign tax credit) if the proceeds of the tax are used, directly or indirectly, to provide a subsidy to the business conducted by the taxpayer. 26 C.F.R. 4.901-2(f)(3)(ii). The court of appeals upheld this regulation as a reasonable interpretation of the pertinent statutory language. The court further concluded that the amounts rebated to Brazilian borrowers represented indirect subsidies to petitioners within the meaning of the regulation (Pet. App. 5a-11a). Having concluded that this case is controlled by the regulation, the court expressly declined to consider whether the amounts that Brazil received from—and then rebated to—Brazilian borrowers were not, in substance, a tax paid to Brazil (*id.* at 11a n.6).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Indeed, the decision in this case follows the same analysis and reaches the

same conclusion as the only other appellate decision directly on point (*Continental Illinois Corp.* v. *Commissioner*, 998 F.2d 513, 518-519 (7th Cir. 1993), cert. denied, 114 S. Ct. 685 (1994)). Moreover, for all years after 1986, Congress has authoritatively resolved the questions presented in this case by enacting Section 901(i) of the Internal Revenue Code, which codifies the position taken by the Commissioner. See 26 U.S.C. 901(i). Further review of the decision of the court of appeals is therefore not warranted.

1. a. Section 901 of the Internal Revenue Code allows taxpayers a credit against their federal income tax liability for "the amount of any income * * * taxes paid or accrued during the taxable year to any foreign country." 26 U.S.C. 901(b)(1). Section 4.901-2(f) of the Temporary Treasury Regulations interprets the language "paid or accrued" in Section 901 of the Code. Under that regulation, an amount of tax that the foreign country is expected to refund is not deemed a tax paid or accrued (26 C.F.R. 4.901-2(f)(2)). The regulation further provides that an amount of tax that the foreign country uses to provide a subsidy (determined by reference to the amount of the tax) to the taxpayer is not deemed a tax paid or accrued (26 C.F.R. 4.901-2(f)(3)(i)).

Brazil did not provide a direct subsidy to petitioners that comes within this provision. But the regulation also addresses the rebate of foreign taxes as indirect subsidies (26 C.F.R. 4.901-2(f)(3)(ii)):

> A foreign country is considered to provide a subsidy to a person if the country provides a subsidy to another person that—
>
> * * * * *

> (B) Engages in a business transaction with the first person, but only if the subsidy received by such other person is determined directly or indirectly by reference to the amount of income tax * * * imposed by the country on the first person with respect to such transaction.

The court of appeals concluded in this case that the rebate by Brazil of taxes collected from Brazilian borrowers, and then automatically returned to them, represented an indirect subsidy within the scope of this regulation (Pet. App. 7a-11a).

b. Petitioners contend (Pet. 14-18) that the interpretation of this regulation by the Eighth Circuit in the present case and by the Seventh Circuit in *Continental Illinois* is inconsistent with the foreign tax credit provisions of Section 901 of the Code.

Treasury regulations are to be upheld "if they implement the congressional mandate in some reasonable manner." *Rowan Cos.* v. *United States*, 452 U.S. 247, 252 (1981) (internal quotation marks and citation omitted). As this Court has explained, "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984). Deference is afforded to the Commissioner's interpretations of the tax statutes because (*National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477 (1979)):

> "Congress has delegated to the * * * Commissioner [of Internal Revenue], not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal

> Revenue Code. 26 U.S.C. § 7805(a)." *United States* v. *Correll*, 389 U.S. [299,] 307 [(1967)]. That delegation helps ensure that in "this area of limitless factual variations," *ibid.*, like cases will be treated alike. It also helps guarantee that the rules will be written by "masters of the subject," *United States* v. *Moore*, 95 U.S. 760, 763 (1878), who will be responsible for putting the rules into effect.

Petitioners do not challenge the provisions in the regulation (26 C.F.R. 4.901-2(f)(2) and (3)(i)) that provide that a tax has not been paid or accrued to a foreign country to the extent that it is to be refunded to the United States taxpayer or is to be returned as a direct subsidy to the business of the United States taxpayer. Nor would those provisions reasonably be subject to challenge. As the courts of appeals have consistently concluded, if amounts paid to a foreign country are similarly used to subsidize the business activities of a United States taxpayer *in*directly, such amounts would no more constitute taxes paid or accrued to a foreign country than would amounts returned to the taxpayer directly. See Pet. App. 9a-10a; *Continental Illinois Corp.* v. *Commissioner*, 998 F.2d at 520.

As the court of appeals explained in this case, it is often difficult, if not impossible, to identify the "actual" recipient of the economic benefits of a governmental subsidy (Pet. App. 8a-9a & n.4, quoting *Con-tinental Illinois Corp.* v. *Commissioner*, 998 F.2d at 519-520). The court noted that the indirect subsidy provision of Temp. Treas. Reg. § 4.901-2(f)(3)(ii) serves the reasonable function of providing an administrable, bright-line test for determining whe-

ther a subsidy has been indirectly provided to the taxpayer (Pet. App. 8a-9a & n.4). The court explained that the regulation accomplishes that end by "defin[ing] cer-tain amounts of tax as subsidies without reference to actual economic benefit" (*id.* at 9a).

As the court concluded, the administrable rule provided by the regulation is a reasonable interpretation of the general provisions of the statute (Pet. App. 8a). Recognizing that the underlying statutory provisions cannot reasonably be understood to authorize a tax credit for taxes that are rebated to the benefit of the taxpayer, the court of appeals (*ibid.*) agreed with the Seventh Circuit in *Continental Illinois*, 998 F.2d at 520, that "[t]he regulation is clear as a bell, and its validity [on this point] cannot be seriously questioned" (Pet. App. 9a).

c. The court of appeals was correct in concluding that the provisions of Temp. Treas. Reg. § 4.901-2(f)(3)(ii) apply to and are controlling in this case. As the Seventh Circuit also correctly stated with respect to identical facts in *Continental Illinois*, 998 F.2d at 520, the regulation "fits this case to a t." The Brazilian "pecuniary benefit"—which effects a rebate of the tax to the Brazilian borrowers who funded and remitted it—represents an indirect subsidy to petitioners within the meaning of Temp. Treas. Reg. § 4.901-2(f)(3)(ii): the rebate is provided to a person (a Brazilian borrower) that engages in a business transaction with petitioners, and the amount of the pecuniary benefit is calculated as a specific percentage of the amount of the tax imposed on the payment to petitioners. The court of appeals thus correctly held (Pet. App. 8a-10a) that, under the regulation, (i) the pecuniary benefit constitutes a subsidy to the

business that petitioners conduct and (ii) the amount returned (or "rebated") by Brazil to the Brazilian borrowers (who paid the tax on petitioner's behalf) is therefore not a creditable tax "paid or accrued" by petitioner for purposes of Section 901 of the Code.

This application of Temp. Treas. Reg. § 4.901-2(f)(3)(ii) is particularly appropriate with respect to the "net" loans involved in this case. Petitioners were paid interest by its Brazilian borrowers at a "net" rate, without subtraction of the Brazilian tax which the borrowers, rather than petitioners, remitted directly to Brazil. Brazil then returned a portion of those tax payments to the borrowers who had remitted them. It would obviously be unrealistic to contend that petitioners—who never remitted any of these funds to Brazil—should be deemed to have "paid" a tax that was returned to those who remitted it. There quite obviously was no "double tax," as petitioners mistakenly contend (Pet. 9): indeed, to the extent that the Brazilian borrowers received *their* payments back from Brazil, it cannot realistically be claimed that anyone "paid" a tax to Brazil, whether on their own or on petitioners' behalf.

2. Petitioners assert (Pet. 15-18) that a subsidy granted by a foreign taxing authority should reduce a United States taxpayer's foreign tax credit only to the extent that the United States taxpayer receives some traceable benefit from the subsidy (Pet. 15).[2]

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[2] Petitioners similarly contend that the court of appeals erred in holding that the indirect subsidy rule of Temp. Treas. Reg. § 4.901-2(f)(3)(ii) applies in the case of Resolution 63, or "repass," loans, on the theory that the repass borrowers were not engaged in any business transactions with petitioners (Pet. 20-21). That contention has been rejected by every court that has addressed it. See Pet. App. 11a; *Continental Illinois*, 998

As the court of appeals noted, however, one purpose of the regulation is to provide an administrable rule that "defines certain amounts of tax as subsidies without reference to actual economic benefit" (Pet. App. 9a). Moreover, petitioners' contention that they did not receive an economic benefit from the Brazilian subsidy lacks both evidentiary and logical support. It is obvious that the ability of petitioners to do business in Brazil was directly assisted by Brazil's determination to reduce the tax burdens associated with petitioners' lendings, by providing a "pecuniary benefit" in the form of a rebate of the taxes that were collected from Brazilian borrowers in connection with such transactions.

In claiming that the Brazilian subsidy conferred no benefit on its activities in Brazil, petitioners rely heavily on an early ruling of the Commissioner that allowed a foreign tax credit for the Brazilian tax (Pet. 15-16). It is quite clear, however, that petitioners are not entitled to rely on private letter rulings respecting the Brazilian pecuniary benefit that were not issued to petitioners. See 26 U.S.C. 6110(j)(3). In any event, petitioners can gain no support from the fact that the Commissioner has reviewed this issue more recently and has revised her position to take account of the information now fully available to her. This Court has often noted that the Commissioner is not

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F.2d at 520 (Resolution 63 loans "fell within the letter as well as the spirit of the subsidy regulation"). Petitioners' suggestion that there is no business connection between petitioners' Resolution 63 loans and the activities of "repass" borrowers is logically flawed, for the stated purpose of Resolution 63 loans was to obtain funding for repass borrowers who otherwise would not be able to borrow directly in international financial markets. See page 2-3, *supra*.

required to adhere to discarded, prior rulings but may revise them as she finds necessary and appropriate in the circumstances. See, *e.g.*, *Dickman* v. *Commissioner*, 465 U.S. 330, 343 (1984); *Dixon* v. *United States*, 381 U.S. 68 (1965). The question ad-dressed in this case is whether the Commissioner's current position is correct. The Seventh and Eighth Circuits have correctly held that it is, and no other circuit has held to the contrary.[3]

3. a. Petitioners contend (Pet. 10-12) that the decision of the court of appeals conflicts with the decisions of the Court of Claims in the Mexican railroad car cases.[4] The Mexican railroad car cases

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[3] In 1986, Congress added 901(i) to the Internal Revenue Code, Tax Reform Act of 1986, Pub. L. No. 99-514, § 1204(a), 100 Stat. 2532, to "clarify and codify" the position that the Commissioner has taken in this case on the subsidy issue S. Rep. No. 313, 99th Cong., 2d Sess. 325 (1986)). Contrary to petitioner's assertion (Pet. 16 n.2, 20 n.3), the enactment of Section 901(i) and the promulgation of regulations under that statute in 1988 do not reflect that the Commissioner's position was incorrect for years before the enactment of that statute and the adoption of implementing regulations. Although the new provision was made prospective in operation, Congress, as petitioner admits (Pet. 16 n.2), explicitly manifested its intention that no inference be drawn from its action as to the validity or invalidity of the regulation in effect before the enactment of the statute. H.R. Rep. No. 426, 99th Cong., 1st Sess. 352 (1986).

[4] *Missouri Pac. R.R.* v. *United States*, 497 F.2d 1386 (Ct. Cl. 1974); *Chicago, B. & Q. R.R.* v. *United States*, 455 F.2d 993 (Ct. Cl. 1972), rev'd on other grounds, 412 U.S. 401 (1973); *Missouri-Illinois R.R.* v. *United States*, 381 F.2d 1001 (Ct. Cl. 1967). See also *Missouri Pac. R.R.* v. *United States*, 301 F. Supp. 839 (E.D. Mo. 1967), aff'd in part and rev'd in part on other grounds, 411 F.2d 327 (8th Cir. 1969), cert. denied, 396 U.S. 1037 (1970).

addressed whether a 10 percent tax withheld from the per diem rentals owed by Mexican railroads for the use of railroad cars owned by United States companies was eligible for the foreign tax credit under Section 901 of the Code. The Internal Revenue Service took the position that this 10 percent charge did not, in substance, represent a tax paid to Mexico because the withholdings were not paid to the Mexican government but were instead retained by the Mexican railroads, as a subsidy for their operations. The Court of Claims, however, rejected the government's contention (*Missouri Pac. R.R.* v. *United States*, 497 F.2d 1386, 1395 (Ct. Cl. 1974)):

> That Mexico elected to appropriate the proceeds of the levies to the benefit of its domestic rail carriers does not mean that the sums involved were not collected from the plaintiff as a tax.

In the present case, the Tax Court (Pet. App. 22a) followed its earlier decision in *Nissho Iwai American Corp.* v. *Commissioner*, 89 T.C. 765, 777 (1987), in which it expressly declined to follow the Mexican railroad car cases. The Tax Court held that to treat the payment of the Brazilian tax as one completed transaction, and payment of the subsidy as a wholly separate event, would be to "ignore the true unity of the transaction and elevate form over substance" (Pet. App. 22a).

Even if, for purposes of argument, it were assumed that a decision as to the United States tax consequences of a tax imposed under Mexican law could be said to conflict with a ruling as to the United States tax effects of a wholly different tax imposed under the law of Brazil, this case could arguably be said to be in conflict with the Mexican railroad car

cases *only* if the court of appeals had adopted the substance-over-form analysis that the Tax Court applied in this case. But the court of appeals did *not* decide this case on that basis. Instead, the court explicitly stated that it would not consider the application of the "substance over form" doctrine in this case (Pet. App. 11a n.6). [5]

As we have discussed, the court of appeals expressly based its holding that petitioners are not entitled to a foreign tax credit with respect to foreign taxes that were rebated to Brazilian borrowers on the provisions of Temp. Treas. Reg. § 4.901-2(f)(3) (Pet. App. 5a-11a). Because that regulation did not exist at the time the Mexican railroad car cases arose and were decided, the decision in this case could not possibly be said to conflict with the decision of the Court of Claims in those cases. [6] Moreover, in concluding that the regulation is valid and that, under its provisions, the rebates Brazil provided to Brazilian borrowers represent indirect subsidies to petitioners, the Eighth Circuit endorsed and followed the reasoning of the Seventh Circuit in *Continental Illinois*, 998 F.2d at 519-520 (Pet. App. 8a-10a). The only two courts of appeals that have considered the questions presented in this case have thus agreed as to the

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[5] While determining that the taxpayer in *Continental Illinois* was not entitled under Temp. Treas. Reg. § 4.901-2(f)(3) to a foreign tax credit with respect to foreign taxes that were rebated to its Brazilian borrowers, the Seventh Circuit rejected as "unsound" the position of the Commissioner and the Tax Court that the foreign tax credit should be denied on "substance over form" grounds (998 F.2d at 519).

[6] Temp. Treas. Reg. § 4.901-2 was adopted in November, 1980. T.D. 7739, 1981-1 C.B. 396, 409.

validity and application of Temp. Treas. Reg. § 4.901-2 (f)(3) to the facts presented here.

b. Petitioners err in contending that the decision in this case is "at odds with" (Pet. 13) this Court's ruling in *Hillsboro National Bank* v. *Commissioner*, 460 U.S. 370 (1983). The *Hillsboro* case has nothing to do with the issues presented here.

In *Hillsboro*, the Court held that, when a bank has paid on behalf of its shareholders a state property tax imposed on the ownership of bank shares, and has received a deduction for that payment under Section 164(e) of the Code, the tax benefit rule does not require the bank thereafter to recognize income when the State, in a separate transaction, refunds the tax to the shareholders. Section 164(e) provides that, when a corporation pays such a tax on behalf of its shareholders, the corporation—and not the shareholder—is entitled to the deduction for the payment of the tax. 26 U.S.C. 164(e)(1) and (2). The Court concluded that, so long as the corporation does not itself receive a refund of the payments for which it claimed a deduction, the refund to the shareholders (which would represent taxable income to them) did not require the corporation itself to recognize income. 460 U.S. at 394-395.

The question addressed in *Hillsboro* did not involve whether the corporation obtained a direct or indirect benefit from the refund to its shareholders of the tax it had paid. By contrast, the right of a taxpayer to a credit under Section 901 for foreign taxes paid or accrued turns precisely upon the question—addressed in the regulation—whether a tax has been "paid or accrued" when it is applied, directly or indirectly, to subsidize the taxpayer's business activities. The issue addressed in *Hillsboro* has no logical

relationship to the question presented and resolved by the court of appeals in this case.

4. As previously discussed (note 3, *supra*), and as petitioners concede (Pet. 16 n.2), Congress has prospectively resolved the question of statutory interpretation addressed in this case by amendments to Section 901 that were enacted in 1986. Petitioners acknowledge that the revised statute "codif[ies] the Commissioner's position on the subsidy issue" (Pet. 16 n.2). See 26 U.S.C. 901(i); note 2, *supra*. Because there is no conflict among the courts of appeals as to the proper application of the statute for years before 1986, and also because the underlying statutory question has been authoritatively resolved by Congress for years after 1986, further review by this Court is not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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In the Supreme Court of the United States

OCTOBER TERM, 1995

NORWEST CORPORATION AND AFFILIATED COMPANIES,
PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY BRIEF FOR PETITIONERS

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1099

TABLE OF AUTHORITIES

Cases: *Page*

Albright v. *United States*, 173 F.2d 339 (8th Cir. 1949) 3

Bowen v. *Georgetown Univ. Hosp.*, 488 U.S. 204 (1988) 3

Chicago, B. & Q. R.R. v. *United States*, 455 F.2d 993 (Ct. Cl. 1972), rev'd on other grounds, 412 U.S. 401 (1973) 1, 2, 5

Continental Illinois Corp. v. *Commissioner*, 998 F.2d 513 (7th Cir. 1993), cert. denied, 114 S. Ct. 685 (1994) 2

Hillsboro National Bank v. *Commissioner*, 460 U.S. 370 (1983) 2

Missouri-Illinois R.R. v. *United States*, 381 F.2d 1001 (Ct. Cl. 1967) 1, 2, 5

Missouri Pacific R.R. v. *United States*, 497 F.2d 1386 (1974) 1, 2, 5

Rowan Cos. v. *United States*, 452 U.S. 247 (1981) . . . 3

TABLE OF AUTHORITIES—Continued

Page

Statutes and Regulations:

Internal Revenue Code:
§ 901 . . . . . 1, 3, 4
§ 901(i) 4

Temporary Treasury Regulations (1980):
§ 4.901-2(f)(3) 1
§ 4.901-2(f)(3)(ii)(B) 5

Miscellaneous:

PLR 7747049 . . . . . 4, 5

PLR 8603008 . . . . . 4, 5

Rev. Rul. 57-106, 1957-1 C.B. 242 . . . . . 4, 5

Rev. Rul. 69-433, 1969-2 C.B. 153 4

Rev. Rul. 78-258, 1978-1 C.B. 239 4

REPLY BRIEF FOR PETITIONERS

In its petition, Norwest showed that the Eighth Circuit's decision in this case is diametrically opposed to the decisions of the Court of Claims in the *Mexican Railroad Cases*, that the Commissioner's expansive interpretation of the Temporary Treasury Regulation to deny Norwest foreign tax credits is inconsistent with IRC § 901, and that the issues presented for review are of tremendous importance to lenders to Brazil who have some $300 million in foreign tax credits at stake. The Commissioner has failed to explain why this Court's intervention is not required to settle this conflict and correct the Eighth Circuit's error of law.

1. The Commissioner acknowledges that the tax court has "expressly declined to follow the Mexican railroad car cases." Br. in Opp. 13. She urges that despite this explicit rejection of the Court of Claims' holdings and despite the totally opposite results below and in the *Mexican Railroad Cases*, there is no "conflict" requiring this Court's attention. This, she claims, is because the Eighth Circuit rested its decision on Temporary Treasury Regulation § 4.901-2(f)(3), which was not in effect at the time of the *Mexican Railroad Cases*. *Id.* at 14. The Commissioner's attempt to avoid the obvious conflict in the lower courts is to no avail, for as we demonstrated in our petition (at 14-18), the temporary regulation, as expansively interpreted by the Commissioner, was *invalid*. Indeed, the *Mexican Railroad Cases*, which interpreted Section 901, demonstrate beyond question that the Commissioner's interpretation of the regulation to preclude foreign tax credits in this case is inconsistent with the statute.

Moreover, the Commissioner's quibble that there is no true conflict because the cases deal with the U.S. tax consequences of different tax systems—one imposed by Brazil, the other by Mexico—is unavailing. Both this case and the *Mexican Railroad Cases* decided the same issue—whether a taxpayer is entitled to a credit for foreign income taxes insofar as the foreign government provided a subsidy

in an amount based upon the tax—with conflicting results. The Court of Claims held that the Mexican government's grant of subsidies to the Mexican railroads was "wholly an internal Mexican affair that is of no concern to us." *Chicago, B. & Q. R.R.*, 455 F.2d at 1023; see Pet. 10-12. In contrast, the Eighth Circuit was very concerned about the Brazilian government's grant of subsidies to Brazilian borrowers—indeed, this "internal" matter was held determinative of U.S. tax consequences. It is undeniable that this case and the *Mexican Railroad Cases* concern the same issue and reach completely opposite outcomes.[1]

2. The Commissioner makes two arguments to support her position that the Temporary Treasury Regulation bars a foreign tax credit in the circumstances of this case. First, she asserts, it is a valid exercise of her power to interpret the tax laws to which the courts owe deference. Second, as the Seventh Circuit reasoned in *Continental Illinois*, 998 F.2d at 519-520, and the Eighth Circuit held here (Pet. App. 8a-9a & n.4), the temporary regulation supplies a bright line that avoids the difficulty of determining who actually reaps the economic benefits of a tax subsidy. Neither argument has any merit.

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[1] The Commissioner's efforts to distinguish *Hillsboro*, 460 U.S. 370, are equally misplaced. The issue in *Hillsboro* was whether a bank, which had paid state taxes imposed on its shareholders and properly deducted the payments, was required to recognize as income the taxes later refunded to the shareholders. This Court reasoned that because the bank and shareholders were "independent of one another," the bank's tax payment was "not negated by a refund" to the shareholders. *Id.* at 394; see Pet. 13. Not only does *Hillsboro* therefore have a "logical relationship" to this case (Br. in Opp. 15-16), because it addresses the effect of a refund in analogous circumstances, but the Eighth Circuit's holding is squarely at odds with the principles enunciated in *Hillsboro*.

While the Commissioner emphasizes the deference owed her interpretations of the tax laws as well as her prerogative to revise her position when she deems it appropriate (Br. in Opp. 7-8, 11-12), she fails to acknowledge that different levels of deference are appropriate in different circumstances. As we showed in our petition (at 16-18), the Commissioner is owed substantially less deference when her position has been inconsistent over the years, as it was here. *Albright*, 173 F.2d at 344-345. And she is owed substantially less deference when her interpretation was not contemporaneous with passage of the statute. *Rowan*, 452 U.S. at 253. Here, her revisionist interpretation came many years after the passage of IRC § 901. Most importantly, the Commissioner is entitled to *no* deference where, as in this case, her position is a "litigating position" that is inconsistent with prior "administrative practice." *Bowen*, 488 U.S. at 212; see Pet. 17-18 (citing authority).

This case shows that the Commissioner's bright line test is unnecessary—or at least overbroad. The Commissioner has admitted that the refund provided no economic benefit to Norwest, but that its implementation left U.S. lenders in "exactly the same" position. Pet. 14. Moreover, Brazil's Finance Minister explained that the purpose of the refund program was to stimulate foreign borrowing to alleviate domestic problems, and had nothing to do with benefitting foreign lenders. *Id.* at 5. The entire premise of the Commissioner's interpretation of her regulation, that there would be factual difficulties in determining whether the lender received an economic benefit, simply does not apply to the Brazilian loans.

In any event, the Commissioner may not promulgate a regulation in conflict with the plain language and policy of the controlling statute. As we demonstrated in our petition (at 14-18), Section 901's provision for credits for taxes "paid or accrued" allows the Commissioner to deny credits only

where a subsidy provides an economic benefit to the U.S. taxpayer—something that the Commissioner herself recognized in revenue rulings and private letter rulings predating the temporary regulation. See Pet. 15-16. The Commissioner fails even to acknowledge the primary purpose of Section 901—the avoidance of double taxation. That purpose mandates an "economic benefit" rule for determining the U.S. tax consequences of subsidies to foreign borrowers.[2]

3. Respondent repeatedly points out that Congress codified the regulation "for all years after 1986" (*e.g.*, Br. in Opp. 6, 12 n.3, 16), as if this change made the issues in Norwest's petition unimportant. But the Commissioner does not deny that over $300 million in foreign tax credits from billions of dollars in loans made before 1986 are at stake here. The Commissioner should not be heard to assert that the tax treatment of those loans is unimportant, and the substantial tax question presented unworthy of resolution. While Congress codified the regulation for loans made after 1986, our petition presents economically very significant issues for the many businesses that made loans before 1986.[3]

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[2] The Commissioner argues that the denial of foreign tax credits is particularly appropriate for net loans, the type of loan at issue here. Br. in Opp. 10. But all that distinguishes net loans from gross loans is who physically remits the lender's income taxes to the foreign government—the borrower in net loans, and the lender in gross loans. A lender presumably takes into account the expected foreign tax credits when fixing the interest rates of both net and gross loans. Who physically remits the tax is inconsequential to the issue of whether the lender "pays" the tax. See C.A. Br. 4-5.

[3] The Commissioner places heavy reliance on Congress's statement that the enactment of IRC § 901(i) and the promulgation of new regulations under the statute should not be taken to reflect on the validity of the Commissioner's position on the meaning of

The inequity of arguing that review should be denied because of changes made in 1986 is also obvious. When Norwest made the loans in issue, lenders to Brazil relied on revenue rulings, private letter rulings, and the holdings of the *Mexican Railroad Cases*,[4] which all indicated that foreign tax credits *were* available.

4. The Commissioner buries the important issue of Resolution 63, or repass, loans in a footnote. This is hardly surprising, for she invents an entirely new legal standard for assessing such loans. Br. in Opp. 10-11 n.2. Ignoring the requirement of Temp. Treas. Reg. § 4.901-2(f)(3)(ii)(B) that only a subsidy to an entity engaged in a "business transaction" with a lender may be considered a subsidy to that lender, the Commissioner substitutes a much weaker standard, holding that there is a subsidy to the lender whenever it has a "business connection" with the direct recipient of the subsidy. The Commissioner then asserts that Norwest and the repass borrowers meet this watered-down "business connection" standard—a standard so expansive and all-encompassing that it would be difficult *not* to meet given the interconnectedness of the modern business world. *Ibid.*

This tactic is transparent, and clearly illegitimate. The plain language of the temporary regulation requires that the parties engage in a "business transaction," not that the parties have some sort of vague "business connection." The

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the earlier statute. Br. in Opp. 12 n.3. We specifically addressed this point in our petition, citing cases in which courts have held that prospective amendments changed the law where Congress purported merely to clarify it. Pet. 16 n.2.

[4] Thus, petitioners did not improperly rely solely on private letter rulings, as the Commissioner suggests. Br. in Opp. 11. Those rulings were mirrored by the 1957 revenue ruling (see Pet. 15) and the *Mexican Railroad Cases*.

history of the regulation, too, demonstrates that it contemplates some actual business relationship between the borrower and the lender. In 1979, the Commissioner rejected proposed regulations that would have precluded a foreign tax credit in the amount of a subsidy whenever the borrower was engaged "directly *or indirectly* in a business transaction" with the lender in favor of the more restrictive "business transaction" language. C.A. App. No. 78 (emphasis added). While the Commissioner champions the temporary regulation when it suits her needs, she toys with its plain language when it does not.

The "business connection" standard now advanced by the Commissioner is an expedient response to the facts presented below, which demonstrate that Norwest and the repass borrowers engaged in no "business transaction." The court of appeals acknowledged as much when it found that in the case of Resolution 63 loans, the transaction between the foreign lender and the borrowing bank was "separate from the transactio[n]" between the borrowing bank and the repass borrower. Pet. App. at 11a. Moreover, Norwest and the repass borrowers could not possibly have engaged in a "business transaction" with each other as required by the temporary regulation, for it is undisputed that Norwest *did not even know the identity* of the repass borrowers. Pet. 3.

In summary, the Commissioner has failed to rebut Norwest's detailed showing in its petition that the lower courts are in conflict on economically important tax issues that require this Court's attention.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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